S. HRG. 100-83

OVERSIGHT OF THE SECURITIES AND EXCHANGE COMMISSION AND THE SECURITIES INDUSTRY

HEARING

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

THE PROPER ROLES OF GOVERNMENT AND OF SELF-REGULATION IN LIGHT OF THE SHIFT IN POLICY FOCUS OF THE SEC IN THE PAST FEW YEARS

FEBRUARY 24, 1987

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE

72-694 WASHINGTON : 1987

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

S241-14

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OVERSIGHT OF THE SECURITIES AND EXCHANGE COMMISSION AND THE SECURITIES INDUSTRY

TUESDAY, FEBRUARY 24, 1987

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, DC.

The subcommittee met at 9:30 a.m. in SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the subcommittee) presiding.

Present: Senators Riegle, Proxmire, Sasser, Shelby, Armstrong, D'Amato, and Hecht.

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. The subcommittee will come to order.

Our first four witnesses will appear as a panel: Mr. Don Marron, Mr. Raymond Mason, Mr. Robert Rittereiser, and Mr. Alvin Shoemaker. I'd like to invite them to come on up and there are name tags at the table if you can find the appropriate seats.

We are pleased to have the witnesses here this morning. I will indicate that we have a number of hearings going on simultaneously on Capitol Hill this morning on the Senate side, which is often the case, so we will have members coming and going at different times.

I'm going to make my opening statement and then I'll call on Senator D'Amato for his comments.

Today we begin the first meeting of the Securities Subcommittee in the 100th Congress with an oversight hearing of the securities industry and the Securities and Exchange Commission.

In the near future the subcommittee will be reviewing the authorization of the Commission itself. Prior to that time, I have invited some of the most highly regarded leaders and practitioners in the securities industry to address some fundamental and essential questions. They include the following.

First, how do we strike the proper balance between the role of Government in the regulation of the securities markets and the industry role of self-regulation? The proper roles of Government and of self-regulation are important ones in light of the shift in the policy focus at the Commission in the past few years. That shift has recommended increasing reliance on self-regulatory organizations to police the markets and enforce the securities laws as well

as to govern investment advisers and investment companies, small business investment companies and financial planners.

With each new charge of insider trading and security laws violations, it becomes increasingly difficult to avoid the conclusion that there has been a real, even if temporary, breakdown in the self-regulatory mechanisms of the industry.

The basic goals and purposes of the securities laws are also being questioned these days. Traditionally, the Securities Act of 1933, the Truth-in-Securities Law, was widely interpreted as having two basic objectives: one, to provide investors with material financial and other information concerning securities offered for public sale; and two, to prohibit misrepresentation to seed other fraudulent acts and practices in the sale of securities generally.

The Securities and Exchange Act of 1934 extended the disclosure doctrine of investor protection to those securities listed and registered for public trading on our national securities exchanges.

Underlying both these laws was a concern for the individual investor. Today the argument is being made by some that the basic goal of the securities laws should be economic efficiency. Whether notions of economic efficiency as an over-arching goal of securities laws is consistent with notions of investor protection and market fairness is another basic and essential issue.

Throughout these hearings a primary concern of mine will be to ensure that the individual investor continues to get a fair shake in our capital markets.

A second question I've asked our witnesses to address is this. What, if anything, should the Commission be doing which it is not presently doing, and what improvements, if any, would they recommend making in the regulation of the securities markets?

Topics in this area which immediately come to mind involve several items, including the growing internationalization of our capital markets, and its impact on the competitiveness of the U.S. financial services industry. This is a matter of some concern to me.

Another relates to the recent volatility in our markets and the role played by new market developments, including program trading and portfolio insurance.

The stock market dropped 121 points September 11 and 12, 1986, and 114 points during the course of the day on January 23 of this year. Another triple witching hour comes up later this month and sophisticated commentators are increasingly concerned about what this volatility means to the individual investor and how best to protect against a possible future meltdown of the market.

Then, there is the issue of insider trading and those regarding the tender offer process, the latter of which is being taken up at the full committee level.

The third and final question I have asked our witnesses to address is this. Does the SEC currently have adequate resources to do its job correctly and does it possess adequate remedies to deter securities laws violations?

The Commission in the past 2 years has been criticized on this score by a number of members of the Securities Bar, the General Accounting Office, and the financial press.

For example, Richard M. Phillips, the past president of the committee on Federal regulation of securities of the American Bar Association expressed considerable concern last year and I quote him:

> * * * over the ability of the Commission to maintain the quality of disclosures in connection with the public offerings of securities

and testified,

> In all my years of securities practice, I have never been more concerned about the adequacy of the SEC's resources to prevent fraud, promote full disclosure, and otherwise safeguard our securities markets.

The GAO in the past few years has issued numerous reports pertaining to the SEC, an underlying theme of which has been the need for more resources.

And in the financial press, a number of articles have appeared along the lines of that published in the Wall Street Journal dated December 16, 1985, entitled "Inundated Agency, Busy SEC Must Let Many Cases and Filings Go Uninvestigated."

Also, one current SEC commissioner has recommended that legislation should be enacted granting the SEC express authority to impose civil money penalties and the suggestion has been seriously advanced that with a $114 million agency, which is arguably underfunded, that maybe the penalties imposed for insider trading violations should go directly to the Commission rather than to the U.S. Treasury.

These are some of the thoughts that I had in mind in framing the three basic questions which are the subject of these hearings, but they are meant in no way to preclude the witnesses from testifying exactly as they see fit within the very broad framework that has been outlined.

Finally, in light of recent events, it is necessary to ask our panels for their recommendations on how we should deal with the ongoing scandals on Wall Street and what should be done to ensure better supervision and compliance with the laws on the part of our securities institutions.

I feel today that we have two truly outstanding panels of witnesses. I am pleased that they are here and it is my hope and expectation that their testimony will assist both the subcommittee and the Commission in setting our future agendas.

With that, Senator D'Amato.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, let me commend you for calling these hearings which are most timely. I look forward to working with you, Mr. Chairman, in addressing some of the concerns that you have brought forth and mentioned.

The reputation and integrity of the securities industry, whether deservedly or undeservedly, has certainly been jeopardized by the recent revelations and there is a perception of a pervasiveness of greed, fraud, and corruption.

Unfortunately, a very few have created this perception. The hundreds and hundreds of thousands of people who work in this important area of capital formation have been tainted as a result of the Boeskys and the Levines, but I think it's important that we recognize that reform is necessary and that simply to talk about the

problems without coming forth with the kind of definite legislative initiatives would be a terrible failure on our part.

I believe we are going to have to come forward and define insider trading more clearly and certainly no one needs a definition to know that someone carrying around a valise with $700,000 has been guilty of a serious crime. We understand that. Those crimes committed by the Levines and Boeskys don't need better definition. But we'd better understand, and if we're really going to address this—and I'm sure our very distinguished panelists will touch on some of the ramifications of the necessity to further clarify and define insider trading, the imposition of civil sanctions upon those firms that know or should have known that its employees were making these kinds of deals.

We're not talking about holding them accountable for someone in the basement operation that they had no way of knowing, but certainly where there are the cases where they had a responsibility to know that various activities were taking place that should have caused them some concern, those firms themselves should be held accountable. I have put forth 2 bills which I attempt to define insider trading in a way which facilitates the prosecution of these crooks. I hope these bills provide a catalyst for an in-depth examination of this issue and will lead to a statutory definition of the crime of insider trading.

I'm going to ask that the full copy of my remarks be put into the record as if read in their entirety so we can hear from our panelists.

Senator RIEGLE. We will do so.

Senator D'AMATO. I would simply like to say that I think it's absolutely incumbent not only that we provide the legislative initiatives to deal with some of these problems, but also that we bring about a new spirit and determination from the leaders of Wall Street and the legal community that they themselves undertake what is most responsible—they take the initiative and the leadership to bring about a change in perception in Wall Street, that the deal is not the most important, and that it's the manner by which we accomplish the job that is also important.

The moral guideposts have come down. Critics of the street liken it to a casino and the general public may soon begin to think that the casino is rigged against them. That is a terrible, terrible situation that could bring about devastating results in the capital formation system of this Nation. A system which is the underpinning of this Nation's strength.

Mr. Chairman, I commend you for calling these hearings and I look forward to hearing from our distinguished panel.

[The complete prepared statement of Senator D'Amato follows:]

STATEMENT OF SENATOR ALFONSE M. D'AMATO

I would like to commend Senator Riegle for assembling such a prominent group of securities executives and lawyers for this, The Securities Subcommittee's initial hearing of the 100th Congress. Today's hearing comes at a time when great turmoil exists in the securities markets. The stock market, while reaching new highs almost daily, has also experienced wild gyrations caused by a new phenomena, program trading. Corporate takeover activities continue unabated. Finally, Wall Street seems bent on confirming our worst fears about the pervasive corruption on the street

through the monthly revelations of insider trading scandals committed by those occupying the upper echelons of prestigous securities firms.

The reputation and integrity of the securities industry, whether deservedly or undeservedly, has been jeopardized by recent revelations of the perceived pervasiveness of the greed, fraud, and corruption of Wall Street. The demise of Levine, Boesky and Siegel has seemingly confirmed certain congressional and public prejudices of Wall Street as a casino with only dollar signs as moral guideposts. Hardly a day goes by without a headline in the Wall Street Journal, the New York Times, or the Washington Post which trumpets congressional alarm about the excesses of a stock market that resembles a casino rather than the fair and orderly security markets that the Federal securities laws were designed to promote. Newspapers and the airwaves have been flooded with congressional pronouncements promising drastic reforms of the current regulatory structure of the securities industry.

The momentum for legislative reform increases as this list of Wall Street casualties grows. Hopefully, the image of once-respected Wall Street professionals being led off in handcuffs like common criminals will cause market professionals to realize the real legal implications of misconduct while restoring some investor confidence in the market. I believe the recent prosecutions serve two purposes. First, the prosecution of insider traders and the sanctions imposed upon them should deter those who are tempted to engage in illegal insider trading. Second, it should demonstrate to the investing public that the institutions such as the SEC are functioning properly and that the system is working.

Despite the SEC's vigorous prosecution of insider traders over the past 6 years, the most recent prosecutions have shocked the investment community, the public and members of this panel in much the same manner as did the revelations of the market abuses that led to the crash of 1929 and the passage of the Securities Exchange Act of 1934. The Prosecutions of Levine, Boesky, Seigel and others have shaken public confidence in the securities markets.

The fallout from these scandals will be that the public will lose more and more confidence in the integrity of the marketplace and those professionals who work in that market upon the revelation of more insider trading schemes. The popular perception I have witnessed is that the small investor and the public believe that insider trading is the rule on Wall Street rather than the exception. It appears that Wall Street has recently been living up to the peoples' worst expectations. The public cannot help but think that the dice are loaded, the game is fixed or the cards marked after reading the startling facts surrounding the recent scandals.

If steps aren't taken to change this perception and restore public confidence, the public is going to exit from the market and not come back. The continued erosion or total loss of public confidence in the basic integrity of the markets and the institutions and mechanisms designed to assure the fairness and integrity of those markets must be reversed. The members of this Subcommittee must dedicate themselves to drafting legislation designed to further deter insider trading and restore some semblance of order in contests for corporate control.

While the questions before the subcommittee today are important, I suggest that we must soon turn from an examination of the issues and seriously begin to consider specific legislative proposals designed to address the market abuses highlighted during our hearing this morning—a hearing which in many ways is a continuation of hearings the Securities Subcommittee held in the 99th Congress. Specifically, I would like those witnesses appearing before the subcommittee to address several legislative proposals which would: one, define insider trading; two, impose civil sanctions upon firms that knew or should have known that its employees were trading on the basis of inside information; and three, provide comprehensive reform of the Williams Act.

These proposals are embodied in S. 227, the Tender Offer Reform Act of 1987; S. 230 the Insider Trading Definition Act; and S. 231 the Insider Trading Reform Act.

I view these proposals as the start of the process which will lead to amendments to the Securities Exchange Act of 1934. A failure to address specific legislative proposals in the near future will do little to restore the public's confidence in the integrity of the securities markets. I urge all of the witnesses appearing before us today to comment on the adequacy of these proposals and ways in which they might be improved.

In considering these legislative proposals, we must remember that laws alone cannot restore the damaged reputation of Wall Street and in turn restore public confidence in the integrity of the securities markets. The securities industry itself must take steps to restore the public's confidence in the integrity of the securities markets. It is incumbent upon those of you who earn a fantastic living through your positions of power and prominence in the markets and in law firms to imbue some

sense of morality and ethics into their young executives and associates. The new players in the market have come into a go-go environment. It appears to them that success is measured in the amount you earn—the ends always justifying the means. It seems that, doing the deal, always important on the street, has become paramount without any regard to whether the deal will be done legally or illegally. Something has to be done to change this perception of the street. The people who must take the initiative are the leaders of the securities industry and the securities bar.

Senator RIEGLE. Thank you, Senator D'Amato.
Senator Sasser.

OPENING STATEMENT OF SENATOR SASSER

Senator SASSER. Chairman Riegle, I want to also commend you for holding these oversight hearings today. I believe that these hearings will lay a sound groundwork for a searching review of the current state of the securities market.

I might say, Mr. Chairman, to you and the other members of the committee, that in my judgment, the securities market is at a crossroads. The industry is buffeted almost daily by far-reaching scandals relating to insider trading and we see that far too many of the high ranking executives and some of the most prestigious securities firms in this country are in danger of trading their pinstripes in for prison stripes.

Consider the public spectacle of the excesses we have recently seen. Dennis Levine uses insider information in about 54 takeover attempts and he reaps a profit of some $12.6 million. Ivan Boesky has already paid $100 million to settle civil complaints related to his stock manipulation.

In just one instance, Mr. Boesky is alleged to have profited to the tune of $28 million.

Now it's unclear whether these instances of insider trading and stock manipulation are but isolated cases, which I tend to think they are, or whether there are abuses abroad in the securities industry that are too commonplace in this fast-paced market that we find ourselves in today.

I think, Mr. Chairman, that the committee has a clear mandate in several respects.

First, I think the committee should continue its oversight of the securities industry through these hearings. In time, I believe that a further, more intensive investigation of the problem of insider trading is warranted.

In that regard, I trust that the Securities and Exchange Commission and the Justice Department will provide this committee with the fruits of their investigation and that we may fully understand the nature and extent of insider trading activities in the securities market.

Second, Mr. Chairman, I believe that this committee should in a timely fashion structure legislation that shines the light on the stock manipulations that are at the heart of corporate takeovers in this country today. I believe that the time for 13(D) filings should be substantially shortened from the current 10-day period and that these filings might be in order whenever there is a purchase of more than 2 percent of a company's stock.

Third, I believe the committee should lend its full support to both expanded SEC enforcement efforts with regard to insider trad-

ing and also assist the SEC in beefing up its activities with regard to the review of securities registrations, annual reports, and the like.

Finally, Mr. Chairman, I think the committee should encourage in the strongest terms possible all self-regulatory organizations to clearly and honestly review their efforts to prevent abuses like insider trading.

We have an obligation here to the American public and we must act forcefully to protect the integrity of our securities market for both the small investor and the large corporation alike.

Mr. Chairman, I look forward to hearing the testimony of these distinguished witnesses today and it's my view that they can shed some light on this overall problem. Thank you.

Senator RIEGLE. Thank you, Senator Sasser.

Senator Hecht.

OPENING STATEMENT OF SENATOR HECHT

Senator HECHT. Thank you, Mr. Chairman. I, too, want to commend you on having these hearings.

I take somewhat of a different attitude. I don't think the securities industry should really take a defensive position. I think that you should point to the fact that in the last few years 13 million new jobs have been added to America, mainly because we've had a good working securities industry and the fact that there's a couple of rotten apples in the barrel no more reflects on your integrity than when a few years ago a couple Members of Congress was sentenced to prison. I don't think that the public has lost their respect.

We now have the highest volume in history and so obviously people still have respect for that industry.

I think we should proceed with caution on any type of legislation that we might introduce. I think it's very important to hear from people like yourself who are involved in the industry, and as a general rule, it's always very dangerous to legislate in the heat of anger.

So I will be waiting to hear from all of you.

Senator RIEGLE. Thank you, Senator Hecht.

Senator Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Thank you, Mr. Chairman.

Mr. Chairman, I join the other members of the committee in commending you on holding these hearings and the all-star group of witnesses that you have assembled here, and also for asking our witnesses to address the very fundamental questions that you posed in your opening statement.

I hope our panelists will respond with considerable detail to the thrust of your last two questions in particular; namely, one, what improvements should be made in the regulation of our securities' markets and what should the SEC be doing which it is not presently doing to bring them about; and two, does the SEC currently have adequate remedies to deter securities laws violations and sufficient resources to police and punish those violations that do take place?

With respect to the first question, it seems that the SEC must play a much more aggressive role in policing our securities' markets as there appear to be real shortcomings in this industry's ability to police itself. I would hope our witnesses would address themselves to that growing perception.

With regard to the second question, I note that the SEC has called for additional resources, particularly in the enforcement division, something like a 30 percent increase in their overall budget, and this makes sense from every standpoint, including even Gramm-Rudman, because as you know they bring in far more than they cost. One fine of one individual last year brought in more money than it costs to run the entire SEC for a year.

Let's face it. Congress created the SEC more than 50 years after intensive congressional investigation revealed widespread manipulation and victimization of public investors by market insiders. A lot of people then counseled, as some do now, that we should be cautious, we shouldn't do anything, we should take it easy, that the market will regulate itself. But Congress recognized that we had to take action. We did. We took very good action—the Securities Exchange Act set up the SEC and I think that's one of the reasons we have had the most widely respected capital markets in the world.

For years the SEC protected the interests of investors and the general public interest in sound securities markets which after all is essential to our country's economic well-being. Too often in recent years under this administration the SEC has pulled in its horns following the slogan of "the market is the best regulator." Events of the past year reveal that a vigilant cop on the beat is absolutely essential to the maintenance of honesty in our securities markets.

This is particularly true in view of the vast monetary rewards that dishonest behavior can bring to those who permit greed to cloud their minds. A cop with a billy club can help dispel such clouds and the SEC must be that cop.

Senator Riegle, you have done an outstanding job assembling such a prestigious group of witnesses for your first subcommittee hearing. I look forward to hearing from them. I also congratulate you on your new chairmanship of this subcommittee. It goes without saying that I look forward to working with you very closely in dealing with the hostile corporate takeover issue which we have agreed should be handled at the full committee which I chair.

Thank you very much.

Senator RIEGLE. Thank you, Senator Proxmire, and I too look forward to having that kind of very fine working relationship which we have always had and always will have.

I want to acknowledge in calling upon Senator Armstrong your movement into the ranking position on this committee, and we have worked together over many long years in both the House and the Senate and I look forward to our chance to work together and I might say you follow in the footsteps of Senator D'Amato who was a very fine chairman of this subcommittee and with whom I have also greatly enjoyed working. He's taken the leadership as well on the insider trading issue, and so I look forward to working with both of you and all the members on the minority side, but I cer-

tainly would invite your comments at this time, Senator Armstrong.

OPENING STATEMENT OF SENATOR ARMSTRONG

Senator ARMSTRONG. Mr. Chairman, thank you very much.

It appears to me that you have come to the chairmanship of this committee just at the moment when the fat is in the fire and I wish you much success. I wish us all success in dealing with the problem.

I am concerned about two or three things and I approach the task we have ahead of us today and this year with a substantial amount of intellectual humility because I know there's a lot about securities law that I don't know, but the first thing that occurs to me is that we need to be very careful that we don't develop legislation which is unrelated to what has occurred.

We are all aware that a number of people have been charged with and appear at least to be guilty of criminal activity. The fact that the law is being enforced ought to be reassurance to us and we ought to draw conclusions based on what's happened.

One conclusion which may come out of this—I'm not ready to jump to this yet, but my initial impression is that there is a lack of clarity about what actually constitutes insider trading.

Now I've talked to a number of people about it, both those who are active in the securities business, some who are or at least hold themselves out to be legal authorities on this subject, and have even done a little reading of the scholarly literature. And there is some question in the minds of practitioners of what insider trading is.

Over the weekend, and this may surprise you Mr. Chairman, I even read a brief essay by one scholar who thinks that the whole idea of outlawing insider trading is a basic mistake, that there's nothing inherently reprehensible about insider trading and that we ought to repeal existing prohibitions against it and let the marketplace do its job.

Now I find that a somewhat far-fetched conclusion, but it's one that is at least worth considering and I hope, if that is a point of view which is substantially represented in the academic community—and I judge that to be the case because I found it in a standard college textbook is where this article came to my attention—then we ought to at least hear that point of view, too.

So I approach the work we're about to do, the hearing this morning, in what I judge will be a busy and active year with an open mind and really with great interest.

Senator RIEGLE. Thank you, Senator Armstrong.

Senator Shelby, a new member of our committee, we are delighted to have with us.

OPENING STATEMENT OF SENATOR SHELBY

Senator SHELBY. Thank you, Mr. Chairman. I want to commend you as the others have in your leadership in the timely call of this important hearing today.

Fifty years ago preceding the 1929 crash of the stock market, the public was outraged by the revelations of stock manipulations, insider trading and coups. In response to this, Congress enacted the Securities and Exchange Act of 1934 creating the Securities and

Exchange Commission and establishing a regulatory framework for the securities market.

Today, we are again shocked by the headlines of the growing, abhorrent scandal on Wall Street. At first, we were told that the scandal only involved a few people, just a few bad apples, as every institution has from time to time.

However, the number of participants in the scandal has mushroomed, reflecting a corporate culture whose deity is the bottom line. The real crime of these events is not just the callous disregard for the law, but the resulting shaken public confidence and trust in our financial and capital formation system.

Insider trading jeopardizes and it undermines the public's rightful and necessary expectation of fairness. Individual investors will grow reluctant to risk their money if they believe that the market is a gain for insiders illegally using material nonpublic information to their own advantage.

The U.S. securities markets I believe are the best in the world. They are the most active, the most efficient, and the most effective. This effectiveness has been premised upon integrity, fairness and strong public confidence. At a time when our capital markets are facing increasing competition from abroad, these scandals could not have come at a worse time.

I want to commend the SEC and its hard-working and dedicated staff in fulfilling its responsibility to try to maintain public confidence in the system and their response to the emerging scandal. A staggering increase in trading volume and the growing complexity of market transactions present the SEC with a constant and an enormous challenge.

Clearly, the SEC requires additional resources. One of the key issues that concerns me is the effectiveness of the surveillance systems. Are they effective in ferreting out market activity and in prosecuting illegal trading? Are the firms' internal monitoring systems effective in educating its employees as to regulations governing insider trading and deterring and detecting abuses?

I am also concerned, Mr. Chairman, about the extent that foreign governments are cooperating with the United States in uncovering illegal trading. I am further concerned that the statutory and regulatory framework banning insider trading may need to be revamped.

Prior to the Insider Trading Sanctions Act of 1984, insider traders were required only to disgorge their illegal profits which was not much of a deterrent. Under the 1984 act, treble damages are imposed. The 1984 act was enacted to deter insider trading, but apparently has not been a sufficient deterrent.

Perhaps it is again time for a stronger response to curb these continuing abuses. These hearings present us with the opportunity to explore fully all the desirable alternatives and then to take appropriate remedial action.

While we do not want to damage the liquidity of the marketplace, we must see to it that adequate regulations and safeguards exist to protect the public and preserve the integrity and fairness of our securities markets.

Thank you, Mr. Chairman.

Senator RIEGLE. Thank you, Senator Shelby.

Gentlemen, let me say I think this turnout of members today and their opening statements gives you a sense for both the serious interest and the constructive interest that we have as a Senate, as a committee, as a subcommittee, in wanting to understand these issues and decide what steps may be appropriate at this time.

So it's in that spirit that we are very interested in hearing from you today. Let us start with you, Mr. Marron. We have your statement. If you would like to summarize it for us as you go, that would be fine, and please proceed at this time.

STATEMENT OF DONALD B. MARRON, CHAIRMAN AND CEO, PAINE WEBBER GROUP, INC.

Mr. MARRON. Thank you very much, Senator. I would like to summarize my statement if I could. I am Donald B. Marron. I am chairman of the board and CEO of Paine Webber Group, which is a publicly held corporation and a financial services holding company.

I would first like to take the opportunity, Mr. Chairman, to recognize you in your new role as chair of this subcommittee. Knowing you, I have every confidence in the success of you and the committee.

I am also pleased to be here with my good friend and outstanding Senator from New York, Alfonse D'Amato.

I am grateful for the opportunity to appear before this subcommittee to share some of my thoughts on the proper role of the SEC in regulating the securities markets and what improvements might be made in the regulation of these markets.

For the past half century the Commission has done an admirable job of discharging its statutory responsibility to protect American investors. Thanks in significant degree to the efforts of the Commission, our markets have been largely free from fraud and manipulation.

The recent public disclosures of insider trading abuses on Wall Street, however, make it apparent that there are serious and pervasive problems in that area.

NEED FOR EFFECTIVE REMEDIAL MEASURES

It is now obvious that effective remedial measures are needed to deal with the problem if the loss of public confidence in the markets of potentially alarming proportions is to be avoided.

Everybody, from individual investors to managers of pension funds, rely on the integrity of the market pricing mechanisms which are reflected in the newspapers every day. That confidence is absolutely critical and we as a nation cannot afford to have it undermined. The insidious effect of insider trading abuses is that they could erode confidence by causing ordinary investors to believe that the markets are not fair and that the values they read in the papers may not reflect the true values of securities they are holding or want to buy or sell. When people lose confidence in the markets fewer transactions take place and the markets become less efficient and the values erode and the net result is that all investors are adversely affected. These adverse effects make us take the recent allegations of insider trading abuses with deadly seriousness.

The industry and the self-regulatory organizations are redoubling their efforts to make sure their own houses are in order and that opportunities for insider trading abuses have been restricted as much as possible. And, of course, the goal now must be to stop the abusive behavior without also damaging the markets and institutions upon which tens of millions of Americans are relying for significant part of their personal wealth, including more and more of their pensions, and without injuring the markets that represent the core of America's capital-raising capacity.

Congress' assistance in this endeavor is essential and, Senators, I reluctantly conclude that Wall Street cannot solve this problem alone. The stakes are too high. The impact is too broad. It will require the joint efforts of Wall Street and Washington.

I don't have any simple, easy solutions to these problems, but I do have a few suggestions which I hope may be usefully added to your consideration of the matter.

First, steps must be taken to assure that disclosures of material corporate information reach the public more quickly and more effectively. The potential for trading on inside information is enhanced to the extent that material information is not made public quickly, clearly, and as broadly as possible.

Congress should consider legislation to accelerate disclosure of market-sensitive information. Specifically, this should include the filing of section 13(d) reports of substantial stock acquisitions within 2 days of their acquisition, rather than the current 10 days. It should also include acceleration of 16(A) reports of stock transactions by corporate insiders from 10 days after the close of the month to 2 business days after the transaction takes place.

I also believe there must be a more effective job of clarifying for the business community what qualifies in the minds of regulators as market sensitive information and what constitutes insider trading. None of us need a law book to tell us that if a suitcase full of money changes hands something has gone wrong. But when you come off those very explicit and very specific items, you move very quickly into gray areas where even the very best-intentioned of people have to call lawyers and ask questions and more guidelines I think would be very helpful there.

Second, under the present law, groups that actually agree to acquire 5 percent or more of a company's stock have to file section 13(d) reports. Recent revelations of abuses in the takeover area show that tacit understandings arise without the members of the group ever actually entering into an express written or oral agreement. We think the legislation should accordingly be considered that clarifies and strengthens the definition of a "group" so as to ensure appropriate disclosure under section 13(d) of concerted or coordinated activities relating to significant acquisitions of stock in publicly held companies.

Third, an area of focus in multiservice firms is the relationship between the investment banking department and the risk arbitrage departments. In almost every case, multiservice firms have adequate procedures to prevent the misuse of inside information. Most importantly, the firms maintain so-called Chinese walls that separate the risk arbitrage activities from their merger and acquisition work. The broker-dealer firms all need to be even more rigorous in

monitoring the Chinese walls to assure that they are not being breached. In addition, the rules of the exchanges we think should be looked at closely in this area to see if they need to be strengthened.

In considering the issues of insider trading, it's important to recognize that securities markets are becoming increasingly globalized and less and less localized. If we deal with insider trading problems through imposing undue restrictions on trading activities in this country alone while regulations in other countries permit much greater market freedom, we may only have succeeded in driving insider trading activities offshore and that's a new kind of export that won't help our trade problems. I'm sure of that.

ABUSES UNDERMINE CONFIDENCE

Foreign capital flows here because foreign investors have confidence in our markets and more and more of it is coming every day. Insider trading abuses undermine confidence in our markets and could potentially drive foreign investors away.

On the other hand, unnecessary regulatory impediments to the ability of U.S. markets to really compete are not very good also. For example, I think we ought to give serious consideration to the elimination of the short-sale rule. That may sound very technical, but that rule does not exist in foreign exchanges and it will have the effect as those markets grow of simply encouraging transactions to go offshore instead of here because of differences in the regulations. I don't think that's something that we want.

On the domestic scene, we want to support the Commission's efforts of automation and computerization. They are essential to the effective regulation of securities markets. The Commission's EDGAR system—I had to look up what it meant—electronic data gathering analysis and retrieval—deserves the full support of the Congress and should be adequately funded. The great virtue of EDGAR is that it allows for much speedier transmission and, therefore, disclosure of financial information.

To give you an example, we are a public company. If EDGAR was in effect, our financial department could feed its financial reports into Paine Webber's computers which in turn could go directly to the SEC's computer EDGAR, and from there immediately to any financial analyst in the country who wanted to know about Paine Webber. In effect, the information could be gotten much, much quicker, completely accurate, and be seen at the same time as everybody else. We think this is very important and this would enhance market efficiency.

The other thing is, we think that the Commission should also be developing a vastly improved surveillance capability for all U.S. markets. This is an important way to reduce the possibilities of engaging in illegal market activities, including insider trading, and with the advances in computerization, the regulators have to keep up.

Insider trading has not grown in a vacuum, Mr. Chairman. It's part of larger problems created by the vast expansion in our markets. For that reason, other important areas exist that will require thoughtful and innovative approaches. If all the time weren't for

insider trading today I would talk about them in detail, but just to summarize them in one line, the perceived volatility of the markets, including in particular program trading, which you mentioned in your opening statement; the growth in the number of new investment products; and the breakdown in the line separating the components of the financial service industry; and the changes in the investor population, including in particularly the continually increased role of the institutional investor and the relatively declining role of the individual.

I think one other area that the Commission needs to focus on is the tender offer area. Attempts should be made to achieve more balanced rules between target companies and buyers to help reduce the abuses that are being experienced in that area. For example, more diligent consideration should be given to the elimination of so-called greenmail and to the creation of rules that would require the full financing of tender offers before they happen.

All the issues that I've touched on today boil down to what I regard as an unassailable proposition. In a free market economy like ours, public confidence in the fairness and integrity of our securities markets is absolutely indispensible and I think that they have that. Without that confidence, investors here and abroad are not going to be willing to commit the financial resources that are essential to achieving economic growth and its byproducts—jobs and economic prosperity.

This country is already confronting aggressive and highly successful competition from abroad. We cannot hope to meet this competition adequately—and meet our obligations to ourselves—unless our market mechanisms are in working order and confidence in our markets is maintained.

The leaders of our industry appreciate the seriousness of this problem and they are committed to doing what is necessary, but in this case, because of the breadth and depth of it, a very important partnership between Wall Street and Washington is necessary, a partnership that recognizes that the markets do work very well, that they are central to the economy. All we really want to do is to clear up what are clearly major and potentially damaging abuses.

Thank you, Senator.

[The complete prepared statement of Donald B. Marron follows:]

STATEMENT OF

DONALD B. MARRON

Before the

Subcommittee on Securities

Senate Committee on Banking, Housing and Urban Affairs

February 24, 1987

Mr. Chairman and Members of the Subcommittee:

My name is Donald B. Marron. I am Chairman of the Board and Chief Executive Officer of Paine Webber Group, Inc. ("Paine Webber"), a publicly-held corporation and financial services holding company. Through its subsidiaries, Paine Webber engages in a broad range of securities activities nationwide and overseas. These activities include the provision of broker-dealer services for both the securities and commodities markets, investment banking services, research services, and advisory services to a complex of mutual funds.

I am grateful, Mr. Chairman, for the opportunity to appear before this Subcommittee to share some of my thoughts on the three issues raised in your invitation, namely:

1. What should be the role of the Government in regulation of the securities markets and what should be the role of self-regulation?

2. What, if anything, should the Commission be doing which it is not presently doing and what improvements, if any, would I recommend making in the regulation of the securities markets?

3. Does the SEC currently have adequate resources to do its job correctly and adequate remedies to deter securities law violations?

I. INTRODUCTION

Congress created the Securities and Exchange Commission ("SEC" or "Commission") over 50 years ago in the wake of the financial debacle of 1929 and the ensuing Great Depression. Investigations of that debacle revealed widespread manipulation and victimization of public investors by concealment of relevant information and other forms of outright fraud. Congress recognized that, if confidence were not restored in the securities markets by eliminating inappropriate dealings in securities, investors would be unwilling to risk their capital and the very continuation of the free market system would be called into question.

Congress responded by enacting the federal securities laws and by creating a new federal agency in 1934, the SEC, to administer those laws. The fundamental purpose of the securities laws was then, and still remains, to protect investors by requiring that companies which issue securities make full disclosure so that investors are aware of potential risks. Investors are protected through regulation of the securities markets, of the brokers through whom they deal, and of the people who advise them. Comprehensive antifraud provisions serve as a back-stop for abuses which the regulatory scheme fails to prevent.

For the past half century, the Commission has, by and large, admirably performed its mission of protecting investors under this statutory scheme. We have seen the development of a vast free market capital-raising mechanism based upon investor confidence. Central to the maintenance of these capital markets is the work of the Commission, for it is based in significant degree on the Commission's oversight activities that investors, the public, and the public's representatives have come to expect markets free from fraud, manipulation and deceit.

Today, however, the recent public disclosures of insider trading abuses on Wall Street make it apparent that there are serious and pervasive problems in that area. Some are now suggesting that the abuse of inside information, particularly in the takeover area, may be endemic. The coming weeks and months will undoubtedly shed further light on just how pervasive this insider trading problem really is. But it is now perfectly obvious -- if it was not before -- that effective remedial measures are needed to deal with the problem if a loss of public confidence in the markets, of potentially alarming proportions, is to be avoided.

As you know, everybody from individual investors to managers of pension funds rely on the integrity of the market pricing mechanisms which are reflected in the price quotations that are reported in the newspapers every day. That confidence is so absolutely crucial that we as a nation cannot afford to have it undermined. The insidious effect of insider trading abuses is that they begin to erode this indispensable confidence by causing

ordinary investors to believe that the markets are not fair and that the values they read in the papers may not reflect the true values of the securities they are holding or want to buy or sell. This is the core of the evil of insider trading abuse that has to be addressed.

I want to emphasize at this point that it is not just the Congress or the SEC that wants to see corrective action taken. The brokerage industry itself is concerned with maintaining investor confidence in the integrity of the securities markets. Indeed, Paine Webber, along with the brokerage industry at large, has a direct and immediate interest in assuring that the integrity of the market -- and investor confidence in the fairness of those markets -- is maintained. The reason for this is clear: when people lose confidence in the markets, fewer transactions take place, the markets become less efficient, values erode and the net result is that all securities firms and all investors are adversely affected. It's just that simple. These adverse effects makes us take the recent allegations of insider trading abuses with deadly seriousness. The industry and the self-regulatory organizations are redoubling their efforts to make sure that their own houses are in order and that opportunities for insider trading abuses have been restricted as much as possible. We welcome constructive proposals from all quarters as to how the integrity of the markets, as well as the efficiency of these markets, can be improved.

We are, of course, wary of overreactive solutions that would do more harm than good. The goal must be to stop the abusive behavior without also damaging the markets and institutions upon which tens of millions of Americans are reliant for a significant part of their personal wealth (including, especially, their pension benefits). In other words, while changes must be made to deal effectively with abuses in the insider trading area, these changes must be carefully crafted to deal with the abuses that actually exist without at the same time causing unnecessary injury to markets that represent the core of America's capital raising capacity and upon which tens of millions of Americans are directly reliant. In short, the U.S. markets have been, in their honesty and efficiency, the envy of the free world. It is indispensable to the well-being of all Americans, and Paine Webber's own institutional well-being, that they continue to be so maintained.

The recent revelations of trading abuses by Wall Street insiders further indicate that the Commission's ability to discharge its responsibilities is being sorely tested by the rapid pace of change in the capital markets and the securities industry generally. Change is reflected on a variety of fronts. Over the past several years, there has been a remarkable growth in the globalization of the securities markets with dramatic increases in the foreign trading of U.S. securities and the trading in this country of the securities of foreign corporations. The domestic securi-

ties markets themselves, both primary and secondary, are also rapidly changing under the pressure of increased competition, new distribution techniques, and widespread use of automation. Over just the past few years we have witnessed a proliferation of new and complex products in both the securities and financial futures markets. Along with the development of new types of securities, we have seen a remarkable increase in the volume of securities traded and, some believe, an unsettling increase in the volatility of the markets as new trading techniques, such as program trading and index arbitrage, are introduced. There have also been marked changes in the composition of investors resulting from the increased importance of institutional investors and the movement of individual investors from direct to indirect investment through mutual funds and other institutional media. Change is also reflected in the increased competition between securities firms and banking firms for customer services.

These changes and the pace of change create challenges for the Commission as it tries to stay abreast of new developments in the markets and the industry. In responding to these developments, the Commission is faced with the difficult task of balancing the opportunities presented by innovation with its fundamental statutory goal of protecting investors -- a goal that is no less important today than it was when the Commission first came into being. This balancing act is rendered all the more difficult by the multi-layered structure of U.S. securities regulation. The securities industry is subject to many different regulations, from many difference sources, with many different purposes. At the federal level, regulations affecting the industry are imposed by the SEC itself, the Municipal Securities Rulemaking Board, the Commodity Futures Trading Commission, the Board of Governors of the Federal Reserve System, and others; and the industry is directly and substantially affected by regulations adopted under the Employee Retirement Income Security Act and the Internal Revenue Code. Beyond that, virtually all fifty states, the District of Columbia and Puerto Rico have pervasive regulatory schemes affecting the members of the industry and securities transactions touching their residents. Finally, the stock exchanges and the National Association of Securities Dealers have substantial regulatory authority. Regulatory adaptation to capital market changes must include a reassessment of the regulatory functions performed by these various regulatory components.

While there is not room in this overview to cover all the varied challenges that presently confront the Commission, I would like to discuss seven areas in particular which I believe will require thoughtful and innovative approaches by the Commission and the securities industry during the next several years. These areas are: (1) curbing insider trading abuses; (2) the globalization of the securities markets; (3) problems associated with the increased volume of securities traded and the perceived volatility of the markets; (4) the proliferation of new securities products;

(5) the changing investor population; (6) the appropriate role of self-regulation; and (7) the arbitration of disputes between broker-dealer firms and their customers.

II. CURBING INSIDER TRADING ABUSES

The Commission has already performed an invaluable service in bringing to the public's attention the regrettable fact that insider trading abuses on Wall Street are more than mere aberrations. At least in the takeover area, the abuse of inside information has grown systemic and must be stopped. I have no grand solution to offer to this vexing problem. There is obviously no way to legislate the elimination of greed. That is the driving force behind these insider trading abuses, as it is with many other of the less attractive aspects of our society -- Wall Street certainly has no corner on that market. Nevertheless, while fully acknowledging the difficulties inherent in tackling this problem, I do have several suggestions to offer which I hope may usefully add to Congress' consideration of the matter.

First, I believe that steps must be taken to assure that disclosures of material corporate information reach the public more quickly and more effectively. Obviously, the potential for trading on inside information is enhanced to the extent that material information is not made public quickly, clearly, and as broadly as possible. Of course, most companies do make diligent efforts to comply with the Commission's reporting requirements, but there have been companies that have been delinquent in this regard. Of course, companies that file late or submit incomplete or inaccurate filings should be brought to task by the Commission. In addition, the Congress should consider legislation to accelerate disclosure of market sensitive information. This should include the filing of Section 13(d) reports of substantial stock acquisitions within two days of their acquisition rather than the current 10 days. It should also include acceleration of 16(a) reports of stock transactions by corporate insiders from 10 days after the close of the month to two business days after the transaction. I also believe, however, that there must be a more effective job done of clarifying for the business community what qualifies, in the minds of the regulators, as market sensitive information. I recognize that precise rules cannot be devised in this area, but I can say, as a businessman, that it is often very difficult for companies that have every desire to disclose material information to know precisely what is expected of them.

Second, under the present law, groups that actually agree to acquire 5% or more of a company's stock have to file Section 13(d) reports. Recent revelations of abuses in the takeover area show that tacit understandings arise without the members of the group ever actually entering into an express written or oral agreement. For this reason, I believe that legislation should be considered that clarifies and strengthens the definition of a "group" so as

to ensure appropriate disclosure under Section 13(d) of concerted or coordinated activities relating to significant acquisitions of stock in publicly-held companies. Any legislation in this area would, of course, have to be carefully drafted to ensure that it does not impede legitimate investment activities.

Third, one area that is fraught with the potential for abuse in multi-service firms like ours is the communication of confidential information from the financial or investment banking departments to the risk arbitrage department. In most cases, such multi-service firms have adequate procedures to prevent the misuse of inside information. These procedures include, most importantly, the maintenance of so-called "Chinese Walls" that separate the risk arbitrage activities of these firms from their merger and acquisition work. In my opinion, however, additional steps can and should be taken in this area. In particular, the broker-dealer firms all need to be more rigorous in monitoring the Chinese Walls to assure they are not being breached. In addition, the rules of the exchanges in this area should be looked at closely to ascertain if they need to be strengthened.

I am under no illusion that the foregoing suggestions are sufficient, alone, to entirely eliminate the problems of misuse of inside information. Indeed, there may be no way to prevent surreptitious trading by an unscrupulous investment banker on the basis of confidential information obtained from a corporate client. But the procedures suggested above can be effective in curbing widespread misuse of inside information. I hope that Congress and the Commission will give serious thought to their implementation. I reluctantly conclude that Wall Street cannot solve this problem alone. The stakes are too high. The impact is too broad. It will require the joint efforts of Wall Street and Washington.

I would simply add one word of caution: if we deal with the insider trading problems through imposing undue restrictions on trading activities in this country, while regulations in other countries permit relatively greater market freedom, we may only have succeeded in driving insider trading activities off-shore -- a new kind of export that certainly will not help our trade problems.

III. THE RESPONSE TO CAPITAL MARKET CHANGES

A. Globalization of the Securities Markets

Sophisticated telecommunications systems, the lowering of regulatory barriers, and the search for global investment opportunities have resulted in the globalization of financial markets. It is now commonplace for issuers to cross national borders to raise capital in foreign markets. We consider the globalization of the securities markets to be a positive development for the

Senator RIEGLE. Thank you, Mr. Marron.

Next we will hear from Mr. Raymond Mason, who is the chairman and CEO of Legg, Mason, Wood, Walker, Inc.

STATEMENT OF RAYMOND A. MASON, CHAIRMAN AND CEO, LEGG, MASON, WOOD, WALKER, INC.

Mr. MASON. Thank you, Mr. Chairman. Thank you all for having me here. I did not submit testimony to you previously, and my remarks will be relatively quick.

I'm going to try and touch on each of the questions briefly, assuming that you all are going to question us directly when you get to the question period.

One of the initial issues was the comment that related to self-regulation and, in my opinion, the role of the SEC as it relates to it.

ROLE OF THE SEC

This has been, in my view, one of the finest combinations that is in the world and although we are under pressure right now because of what has happened, if anything, we need to continue to reexamine what we're doing and expand upon it because the very fundamental of the way we have operated in the last 10 to 20 years is envied I guess throughout the world and certainly there is no other market that has the extent of self-regulation that we do.

In regard to the SEC itself, first, my feelings are—and I think everybody shares this—that to a great extent they should be congratulated on what they have been able to achieve and accomplish, particularly in the last several months. The exchanges and others need to be congratulated for their help in what has gone on, but it is incredible what they have been able to accomplish I guess by any scope through any regulatory body.

They have, as all of us know, a very full plate. They are dealing with shark repellants, tender offers, golden handcuffs, junk bonds, 3-B-9, and the list goes on and on. And most of these issues have incredible complexity to them and the type of staff that is needed to accomplish this is something that all of us are beginning to understand.

The world of securities has become very large, not only in this country but throughout the world and it's become an incredibly important factor, therefore, when we come to the last issue that was raised relating to the funding of the Securities and Exchange Commission, it is my view that all the issues that have been raised already—such as EDGAR and computerization—obviously are of importance, but the additional staffing that is necessary—Chairman Shad, in my view, has submitted what he feels is important and is needed, and I would hope that you all would comply with his wishes.

Thank you.

Senator RIEGLE. Thank you, Mr. Mason.

Next we will hear from Mr. Robert Rittereiser, who is the president and CEO of E.F. Hutton Co.

STATEMENT OF ROBERT P. RITTEREISER, PRESIDENT AND CEO, E.F. HUTTON CO., INC.

Mr. RITTEREISER. Mr. Chairman, I am pleased to appear before this distinguished committee to discuss the adequacy of the current regulatory framework in the securities industry. The Congress, and in recent decades this committee in particular, has been a major force in shaping our industry. In the past, we have been blessed by fruitful discussions among the Congress, the SEC and the industry about the ways in which the securities markets serve the public, the goals of the regulatory system and the most effective way to implement these goals. These hearings continue that fine tradition.

I would like to begin by setting out the general principles that guide my consideration of the questions posed by the chairman when I was asked to testify.

The primary goals of the securities industry are to serve investors in investing the savings pool in our economy in an informed and appropriate manner, to raise capital for American business and to participate in the process of making the market pricing mechanism as effective as possible.

The regulatory system that has evolved over the years, and especially the reliance on self-regulation and a strong capital base that have been the particular focus of congressional concern since 1975, is fundamentally sound. And I would like to point out the legislation in 1975 I think was particularly good legislation for dealing with these issues and, in fact, perhaps some of the results of the SEC's good work in recent months has been a result of that legislation.

The search for the perfect regulatory system is essentially the search for balance between governing conduct by rules—which seeks to forestall undesirable behavior at the risk of stultifying legitimate activity—and relying on enforcement, which can be more narrowly focused on undesirable behavior but runs the risk of constantly closing the barn door after the horse is gone.

BALANCE OF ROLES

The second balance that must be struck is between the role of Government and the role of the marketplace. The vitality and diversity of the American marketplace and the increasing efficiency of information flows to broader and broader groups of investment professionals and individuals means that the markets are increasingly able to protect themselves, particularly with the aid of vigorous enforcement. Nevertheless, there is a critical role for regulation to perform.

With that background, I would like to address four developments that have posed major challenges to the regulatory system, and I will make a brief comment on insider trading at the end of this. The issues are: greenmail, the one share one vote issue, program trading, and the internationalization of the capital markets.

GREENMAIL

At the outset, I agree that the possibility of a hostile takeover plays a role in forcing the management of American business to be more efficient. And I also agree that the elimination of greenmail

capital accumulation process and for investors, and its growth and development should therefore be encouraged and facilitated.

Whether the trend toward globalization continues is, of course, very much dependent on the attitudes of individual nations with regard to the perceived benefits of globalization. There is always a temptation to succumb to protectionist sentiments and to close the doors to foreign investment and foreign industry. Many other obstacles to globalization exist: differences in legal and regulatory systems, taxes, exchange controls and investment controls, disparate clearing and settlement systems, and a variety of other obstacles that result from cultural and historic differences in various national approaches to capital formation.

In light of the manifold political and economic factors that influence the globalization process, the Commission's role in influencing this process in a positive way is necessarily constrained, but nonetheless important. The challenge for the SEC is to adapt regulation to the integrated international securities markets in a manner that fosters the competitive evolution of those markets while still providing U.S. investors with the degree of protection to which they are entitled. The Commission must facilitate entry by foreign investors and issuers while guarding our markets' integrity and liquidity.

In order to meet the first challenge, the Commission must be prepared to modify, and in some cases decrease, regulation to accommodate foreign interests. Unnecessary regulatory impediments to the ability of U.S. markets to compete for worldwide business should be eliminated. For example, serious consideration should be given to the elimination of the short-sale rule which does not exist on the London and Tokyo exchanges and which, therefore, simply encourages transactions to be placed through those exchanges rather than through our own exchanges.

Regulation by the lowest common denominator is inconsistent with our own history and values and is obviously to be avoided. But by the same token, we must also eschew the appearance of regulatory imperialism. We cannot unilaterally establish the standards for cross-border trading or arrogantly assume that the U.S. market is so enviable that foreigners will be forced to comply with our requirements regardless of their historical sensibilities. Such an approach will only drive business overseas and create bilateral tensions that will obstruct efforts to liberalize worldwide financial markets and improve international economic cooperation.

Consistent with the foregoing, the Commission should continue its review of disclosure and other regulatory requirements to ascertain whether they are unduly restricting the ability of U.S. markets to compete for business with foreign markets. In 1977, the Commission took initial steps in this direction by adopting

Form 20-F, a disclosure system specifically for foreign private issuers trading securities in the United States. In 1982, an integrated disclosure system for foreign issuers was first adopted that is similar to the system for domestic issuers.

These efforts have proven beneficial. For foreign issuers, the SEC disclosure provisions no longer require as much detail in sensitive areas (such as management remuneration). Further accommodations must now be considered in an attempt to harmonize the disclosure requirements in the United States with the requirements most commonly found in foreign countries. In this connection, Paine Webber strongly endorses the reciprocal approach outlined in the Commission's release entitled "Facilitation of Multinational Securities Offerings." Under that approach, a prospectus accepted in an issuer's domicile which meets agreed-upon minimum standards would be accepted for offerings in each of the participating countries. This approach enjoys the advantage of relative ease of implementation (at least among countries with developed securities systems and for "world class" issuers). It also best respects the different business conduct and traditions of fairness and disclosure in each jurisdiction. We believe the Commission should continue to aggressively pursue the negotiation of such reciprocal arrangements. In particular, we believe that the Commission should be pursuing reciprocal arrangements to facilitate the sale of U.S. investment company shares in foreign countries.

We also believe that the Commission should undertake a thorough review of the application of Securities Act registration requirements with particular reference to institutional transactions in foreign securities. Present Commission requirements often force institutions to buy and sell foreign securities abroad and deny U.S. institutional investors attractive investment opportunities in foreign securities. In our opinion, considerations of investor protection simply do not justify many national restrictions on offerings of foreign securities, both in the United States and abroad, in the context of institutional trading. Players in the international securities market are, and will undoubtedly continue to be, mainly institutions, not individuals. The players will not only be smaller in number, but more sophisticated and better informed. For that reason, concerns of investor-oriented regulation should be somewhat less pressing.

This is not to say, of course, that the Commission may abandon its traditional vigilance in protecting U.S. investors, whether institutional or individual, from fraud and manipulation emanating from abroad. As multinational transactions become more common, each nation seeking to enforce its securities laws will need access to information from outside its borders. The Commission must continue to promote aggressively information exchanges and cooperative enforcement efforts with regulators of foreign markets. The continued success of the international securities markets is dependent on the exposure and prosecution of persons

who abuse these markets by engaging in manipulation and fraudulent activities.

A major problem for the Commission in this regard has been the ability of unscrupulous persons to hide behind foreign secrecy and blocking laws to carry out unlawful activities in this country -- particularly insider trading activities. To meet this challenge, the Commission must be able to gather essential information from abroad while still respecting the internal priorities and customs of other countries to treat financial matters confidentially. The Commission should meet this challenge by more aggressively pursuing bilateral and multi-lateral agreements with foreign regulators for the exchange of information and for cooperative enforcement efforts.

Regulation of the securities markets in the United States is the responsibility not only of the SEC but also of the states and the self-regulatory organizations. The impact of the regulatory practices of these entities in the globalization process also deserves careful consideration.

The extent of state securities, or "blue sky" legislation, varies greatly from state to state. Many states, however, conduct a substantive review of offerings, called "merit regulation." In these states, even though an offering has been cleared by the SEC, the state securities commissioner may deny registration if the offering is found to be unfair, unjust or inequitable. State commissioners may be inclined to deny registration to many foreign issuers because they find the protections offered by foreign securities regulation to be inadequate or otherwise believe that the risks to U.S. investors are otherwise too great. Yet, whatever the merits of merit regulation may be in a purely domestic context, inflexible state regulatory schemes will necessarily interfere with the globalization of the U.S. securities markets. Easier registration with the SEC means little if a foreign issuer cannot offer its securities in states which are key to the marketing effort. Creating new exemptions at the state level may solve part of the problem.

Insofar as the self-regulatory organizations (the exchanges and the NASD) are concerned, we believe that they should be actively encouraged to develop trading links as well as cooperative regulatory relationships with foreign exchanges. The exchanges should review their listing requirements with a view to eliminating unnecessary restrictions on foreign listings. At the very least, an exemption from a one-share-one-vote rule should be provided for foreign issuers. Moreover, disclosure requirements of the SROs, like those of the Commission itself, that go beyond those customarily required in the country of domicile should be reviewed and eliminated whenever appropriate.

B. Volume and Volatility

Telecommunications technology has enabled the securities industry to move from 20 million to 200-million-plus share trading days without serious complication. However, until the advent of the EDGAR (Electronic Data Gathering, Analysis and Retrieval) project in 1983, the filing and dissemination of corporate information had not changed significantly in 50 years. The completion of the EDGAR system is an essential step forward in the application of telecommunication technology to dissemination of information vital to the securities markets. The Commission deserves credit for seeking to bring this system to fruition; it will greatly increase the efficiency and fairness of the securities markets for investors and corporations alike.

Paine Webber believes that EDGAR deserves the full support of Congress and that the system should be adequately funded by congressional appropriations. However, EDGAR must be viewed as only a beginning. Data processing technology systems, like EDGAR, have the potential to revolutionize the manner in which investment decisions are made and executed on the domestic and international securities markets. The United States should be in the forefront of the development and application of this technology.

In the near term, we believe that the Commission should develop improved computerized and/or facsimile filing facilities, as well as data retrieval capacities, for information filed under all of its Acts. The Commission should also develop a vastly improved surveillance capability for all U.S. securities markets. Such capability should extend, in cooperation with the CFTC, to the futures markets. Finally, we believe that the Commission should carefully review its own filing requirements with a view toward ascertaining whether the disclosure of market-sensitive information can be accelerated. For example, the Commission should consider requiring persons who acquire more than 5% of the stock of a registered company to file their Section 13(d) reports within two days of their acquisition (rather than the current ten days). Similarly, the Commission might consider accelerating the time for filing Section 16(a) reports of changes in stock ownership by corporate insiders from ten days after the close of the month to two business days after the transaction occurs.

With the growth in the volume of securities traded, there has been a concomitant growth in the strategies for trading those securities. Two of these strategies -- program trading and index arbitrage related trading[1] -- have come under increasing scrutiny

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1/ Program trading involves an undertaking to buy or sell significant amounts of a large number of securities within a (footnote continued)

and criticism because they are believed in some quarters to be responsible for the perceived volatility of the markets.[2/] Some critics countered that program and index arbitrage trading not only whipsaw the equity markets for no good reason but also are techniques that, even if lawful, are beyond the capacity of the small investor to enjoy.

I believe that these criticisms are overstated and are, in reality, largely unfounded. The futures and options markets add substantially to liquidity of the equity markets and allow much greater efficiency in the allocation of risk among equity traders, large and small. While arbitrage and program trading undoubtedly create occasional short-term volatility surges, there apparently is no convincing evidence that long-term or overall market volatility has increased since the introduction of derivative index products techniques.

This is not to say that all the concerns that have been raised should be dismissed out of hand. The Commission should continue to focus on ways to reduce short-term volatility surges in cooperation with the exchanges and the NASD. We believe that such surges can be ameliorated by changes in trading procedures that do not dramatically change the way stock market trading generally occurs. In considering the relative merits of various alternatives, the respective costs and benefits must be carefully weighed in light of the benefits of derivative index products and the new trading techniques.

Moreover, the Commission must address the concerns of small investors who believe that, whether or not program trading and index arbitrage help or hurt the market in the aggregate, these new techniques hurt them individually. The Commission must approach this problem, not by precluding the institutional investors from using techniques and strategies that have proven beneficial but by exploring ways to educate the small investor and to permit him to participate in the program trading process (for example, through mutual funds that rely on program trading to increase their returns).

(footnote continued from previous page)

relatively short period of time. Arbitrage trading involves attempts to profit from temporary price disparities between the derivative index (futures or option) markets and the underlying stock market.

2/ The most notable example of this volatility occurred in September 11 and 12, 1986, when the Dow dropped a total of 120.28 points.

C. Self-Regulation

Congressional acceptance of government-supervised self-regulation in the securities industry occurred more than 50 years ago when self-regulatory organizations (SROs) were included in the initial effort to impose government regulation on the securities industry. In 1934, when Congress established the SEC, it built into the statutory scheme a considerable degree of self-regulation for the nation's stock exchanges. In the intervening years, Congress has fostered the creation of additional SROs including the NASD (in 1938), the MSRB (in 1975) and the National Futures Association (in 1980). Although the self-regulatory system in the securities industry has sometimes been found wanting, and has been subject to increasing governmental oversight, it occupies a secure place in the regulation of the securities industry and has achieved broad acceptance by Congress as a complement to governmental regulation.

This is not to say that improvements to the self-regulatory system are not needed. One area which we believe deserves serious consideration by the Congress concerns the allocation of functions among the Commission and the SROs as well as the states. The Securities Reform Act of 1975 greatly expanded the SEC's authority to supervise the SROs and to initiate direct regulatory action but it did not adequately establish guidelines for determining to whom regulatory responsibility should be allocated. This absence of guidelines has led to inconsistencies in the treatment of regulatory issues, unpredictability in the establishment of regulatory policy, and the assignment of regulatory responsibilities to the inappropriate regulatory bodies.

To deal with these problems resulting from regulatory overlap and the absence of regulatory guidelines, Congress should establish principles for allocating regulatory responsibility along functional lines. We believe that the SROs should have the primary responsibility for regulating trading,[3/] and providing facilities for the resolution of customer disputes. The states should have primary responsibility for dealing with local complaints. The SEC, while retaining the powers granted by the 1975 Securities Reform Act, should act primarily in an oversight capacity with respect to the SROs and a coordinating authority with respect to the states. Whatever guidelines are ultimately chosen, consideration must be given to the ability of these guidelines to provide predictability and to assure efficient regulation.

3/ See Miller, Self-Regulation of the Securities Markets: A Critical Examination, 42 Wash & Lee L. Rev. 853, 884-87 (1985)

D. Changing Products, Financial Services and Investor Populations

Rapidly changing economic conditions, technological advances and major mergers and acquisitions have engendered the use of many new financial products and services over just the past few years. There has been a proliferation of new and often complex financial products that demonstrate the industry's creative ability to meet changing investor needs but that also call for the equally creative application of new regulatory standards. Along with the creation of new products there has been a marked breakdown in the lines separating the components of the financial services industry so that it has become increasingly difficult to distinguish between the many types of financial services activities by historical industry classifications. Banks now engage in discount securities brokerage and stores, like Sears, now sell securities and insurance along with traditional retail lines. There have also been concomitant changes in the population of investors availing themselves of financial products and services. As is well known, an increasing share of the trading in the domestic markets, and almost all of the trading in the international markets, is undertaken by institutional investors.

The Commission's ability to deal with these new challenges in a timely, efficient and fair way will be severely tested in the months and years ahead. We have no solutions to offer, only a few suggestions.

In order to deal with the proliferation of new products being offered by the securities industry, we believe that the SEC must accelerate its efforts to acquire expertise in those products. Since the Commission's staff generally has no "hands on" experience in the operational side of the financial services industry, it is desirable for them to obtain second-hand experience and guidance through the assistance of industry representatives. Industry advisory committees might be usefully employed in this respect. We believe that it is critical that the Commission not stifle new product development but rather that it fulfill its statutory mandate of protecting investors by ensuring directly and through the SROs that new products are sold with appropriate disclosures and that retail sales forces are properly trained in the new products.

In order to deal with the blurring of lines between the components of the financial services industry, we believe that the Commission must be allowed to regulate along functional lines. This does not mean that the Commission will become a regulator of banks. But if banks enter the securities business they should abide by the same standards and enforcement mechanisms that apply to securities firms under the securities laws. Similarly, as other new types of entities enter or become more involved in securities activities which the Commission is responsible for regulating, they should be subject to the same rules as the traditional actors in the securities markets. If they are not, competition will be distorted and investors will not receive the protections that Congress intended them to receive when it created a federal system of securities regulation.

Finally, in addressing issues related to the changing investor population, the Commission must be sensitive to the special needs of the individual investor and the institutional investor and must recognize that these needs are not monolithic. In that light, the Commission should review its disclosure and other requirements to differentiate between institutional and retail markets and products and should tailor its disclosure and other protections more closely to the needs of each type of investor. For example, institutional investor disclosure requirements should recognize the need for access to detailed financial and other information. On the other hand, individual investor disclosure requirements should recognize that detail often obfuscates and that simplified and more readily understood disclosures should be the goal.

IV. THE ROLE OF ARBITRATION IN SETTLING CUSTOMER DISPUTES

The securities business is largely a business done over the telephone. Each week brokers trade hundreds of millions of dollars of securities on the basis of telephone orders received from their customers. Under these circumstances, it is not surprising that occasional disputes arise between broker-dealers and their customers. To resolve these disputes effective and efficiently, broker-dealers generally require their customers to enter into a written agreement detailing the terms of their relationship before setting up an investment account for the customer. These agreements usually contain clauses that require the arbitration of future disputes. Under the Federal Arbitration Act, agreements to arbitrate future disputes are, in general, specifically enforceable. Notwithstanding that fact, at least until recently, courts have generally held that agreements to arbitrate future disputes are unenforceable with respect to investors' claims under the 1933 and 1934 Acts.

In Wilco v. Swan, 346 U.S. 427 (1953), the Supreme Court held that a predispute arbitration agreement could not be enforced to compel arbitration of a claim arising under Section 12(2) of the 1933 Act. Thereafter, the lower courts uniformly applied the reasoning of Wilco to deny arbitration of federal securities claims, whether under the 1933 or 1934 Acts. Some courts extended Wilco even further to hold that, where state statutory or common law claims arose out of the same facts as -- or were "intertwined with" -- federal securities claims, they could not sever the state law claims or compel their arbitration. A split among the federal circuit courts on this so-called intertwining issue led to the

Supreme Court's recent decision in Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213 (1985). In Byrd, the Supreme Court held that the Federal Arbitration Act mandates that courts compel arbitration of claims pursuant to valid arbitration agreements, even if they must bifurcate proceedings and make a judicial determination of related non-arbitrable claims, unless some other law prohibits arbitration of the matter in controversy. In rejecting the intertwining doctrine, the Court concluded that in enacting the Federal Arbitration Act Congress had evinced an overriding purpose to ensure judicial enforcement of private arbitration agreements.

While the Supreme Court resolved the intertwining question in favor of the severance and arbitration of any arbitrable claims, it left unanswered the question of whether fraud claims under Section 10(b) of the 1934 Act are arbitrable. In October 1986, the Court granted certiorari in a case whose decision should answer this question: McMahon v. Shearson/American Express, Inc., 788 F.2d 94 (2d Cir. 1986), a case in which the Second Circuit held Section 10(b) claims non-arbitrable.

Reversing a long-held stance against the arbitrability of federal securities claims, the SEC has filed an amicus brief in McMahon urging the Supreme Court to find such claims arbitrable. The brief argues that since 1975 the Commission has had extensive authority to oversee and to regulate the arbitration procedures prescribed by the SROs and that this regulatory authority can ensure, and has in fact been exercised to ensure, that such arbitration procedures are adequate to protect statutory rights. In particular, the brief points to the SEC's promotion of the Securities Industry Conference on Arbitration and the SICA's promulgation of a Uniform Code of Arbitration which has been approved by all of its SRO members. The brief concludes that all agreements to arbitrate federal securities-law claims should be deemed enforceable when the arbitration procedures are subject to the Commission's oversight authority, including claims under Section 12(2) of the 1933 Act which the Wilco court held non-arbitrable.

Paine Webber is in strong agreement with the positions advanced by the Commission in its amicus brief in McMahon. There is no justification today for courts to refuse to enforce valid arbitration agreements between broker-dealers and their customers so long as those agreements are in conformity with procedures established by the SROs and approved by the Commission. The arbitration process is, at least in most cases, clearly preferable for both the customer and the broker-dealer to protracted and often enormously expensive court litigation. Legal fees are sharply reduced due to the lack of formal discovery, motion practice, the right to appeal and the need for briefs. The average arbitration proceeding is commenced and concluded within ten months and the average hearing is completed within one day. Arbitration is especially well suited to the resolution of small claims (under

$5,000) because aggrieved customers can appear pro se and incur no legal expenses.

While we are convinced that arbitration of securities disputes, where agreed upon, make eminently good sense for customers and broker-dealers alike, we must acknowledge that lingering perceptions exist in some quarters that arbitration panels at SROs are more partial to the broker-dealer in a dispute since the broker-dealer is a member of that SRO and at least one panelist is from a member organization. Others may believe that arbitration lacks many of the procedural safeguards of court litigation since, for example, arbitrators generally do not issue opinions explaining the reasons for awards and discovery may be severely circumscribed. Some of these objections are, of course, inherent in the arbitration process. For example, parties' concerns for speed and finality of settling their disputes constitutes the main policy for arbitrators not issuing written opinions. Elaborate discovery, while often permitting a more complete understanding of complex fact situations, is obviously inconsistent with maintaining economy in the resolution of disputes.

Nevertheless, for the arbitration process to be truly accepted, the investing public must perceive that process to be fair in fact and appearance. Although we believe that a fair arbitration code has been established for the industry, it is only as good as its application. In this regard, the selection of arbitrators is of critical importance and is an area in which vigilance must be constantly exercised. We believe that the Commission should conduct a thorough review in this area and should again carefully review the arbitration procedures of the exchanges and the NASD to assure that they are actually promoting, and are perceived by the investing public to be promoting, efficiency, fairness and evenhandedness in the resolution of broker-customer disputes.

V. ADEQUACY OF THE COMMISSION'S RESOURCES

As already noted, during the past decade the growth in securities activity and in the Commission's regulatory responsibilities has been explosive. Trading volume in equity securities has increased 700 percent and increases in trading volume for other types of securities have also been dramatic. The number of broker-dealers, registered representatives, investment companies and advisers, and other facets of Commission regulation have increased 100, 200 and even 400 percent. Throughout this period one critically important statistic has shown no increase -- the size of the SEC Staff. Enforcement of the securities laws and the Commission's rules and regulations, together with frequent examination of SEC filings and inspection of regulated businesses, is the keystone of effective compliance. Those subject to Commission regulation must be aware of a continuing SEC presence that can quickly detect and prosecute, where appropriate, serious deficiencies. This vital Commission presence in the securities markets

is being dissipated through inadequate staffing and, if not remedied, could result in a serious breakdown of compliance.

I note in this regard that the President's budget for fiscal year 1988, introduced on January 5, calls for SEC expenditures of $145 million, contrasted with a 1987 budget of about $110 million. I understand that a significant portion of this proposed $35 million increase would be used to expand the Commission's staff and to finance the EDGAR project so that it can be placed on an operational footing during the coming year.

We believe that the President is to be commended for recognizing that the Commission's budget must be sharply increased if the Commission is to have any hope of adequately discharging its statutory responsibilities. In our opinion Congress must likewise assure, in the exercise of its oversight responsibilities, that the Commission has the level of resources that it requires, both in terms of adequate staffing levels and the ability to institute automated systems, to cope with the dramatic growth being experienced in all facets of the securities industry.

VI. CONCLUSION

All of the issues discussed above boil down to what I regard as an unassailable proposition: in a free market economy like ours, public confidence in the fairness and integrity of our securities markets is absolutely indispensable. Without that confidence, investors here and abroad are not going to be willing to commit the financial resources that are essential to achieving economic growth and its byproducts -- jobs and economic prosperity.

This country is already confronting aggressive and highly successful competition from abroad. We cannot hope to meet this competition adequately -- and meet our obligations to ourselves -- unless our market mechanisms are in working order and confidence in our markets is maintained. I am convinced that the leaders of our industry appreciate the seriousness of the problems that confront us and are committed to doing what is necessary to restoring and maintaining that confidence.

The efforts of the Congress and the Commission are indispensable in achieving this good. But given the importance of the goal, and with the exercise of intelligence and good will on all sides, I have no doubt it will be achieved.

will reduce the number of players in the hostile takeover game. That loss does not, in my view, counterbalance the overwhelming fact that greenmail is fundamentally unfair to virtually all real investors, individual and institutional. When greenmail is paid, the investors' money—corporate assets—is used to eliminate a takeover threat. It is a double whammy. They do not participate in the premium paid to the raider, and their own money is used to pay for it.

Moreover, in thinking about whether discouraging some raiders is too high a price to pay, I distinguish between the threat of hostile takeover from another company and a threat which is essentially financial in nature. It is always dangerous to overgeneralize, but I believe that eliminating greenmail will not do much to discourage hostile takeovers that serve strategic business purposes and that the public interest will not lose if some financial raiders are discouraged. As Senator Proxmire recently observed, it is time to get the principal focus of the economy back on business and away from paper transactions.

Finally, it is essential that, in eliminating greenmail, we do not adopt a rule that also eliminates legitimate conduct. Accordingly, I do not support proposals that, following the British model, would require any person acquiring more than a specified percentage of a company's equity—say 20 percent—to acquire the whole company. There may be perfectly appropriate business goals served by owning a minority interest in another company. A better solution, I think, is to simply require that if a company offers to acquire more than a specified percentage of its own shares—5 percent, for example—at a price above market, then the offer must be made pro rata to all shareholders.

On the one share one vote issue, first, it is essential to see clearly what interests are at stake. We are not dealing with a voting right that should be likened to a vote for political office. Investors always have the option to sell a security when they do not like the way a company is being run. The franchise is not widely exercised by investors—except by institutional investors in the case of "poison pills" and other antitakeover devices. The principal function served by voting shares is to buttress corporate accountability, and accountability is generated by the need to face shareholders at an annual meeting, the possibility of a proxy contest, and the threat of a takeover. Although there are many legitimate corporate purposes served by having two or more classes of common stock, the drive to amend the New York Stock Exchange rules is powered by the desire of American business to reduce the ability of an acquiring corporation in a hostile takeover to gain control.

There are two questions that must be asked in considering that proposal. First, will reduction of the voting power held by investors give the board the power to perpetuate itself without effective challenge? I think the answer to that question is, "No." Unlike most mutual institutions, to which some have pointed as a model for what will happen if the one share one vote rule is changed, American business has a constant need to finance. Thus, market participants, including the rating agencies, analysts, and others in the professional investment community are making constant judgments about the quality of management. Those judgments are reflected in the company's ability to finance and the cost of both

equity and debt capital. Moreover, the directors remain subject to their fiduciary obligations to act in the best interests of the shareholders, and the threat of a shareholder litigation is, even today, a sharp prod in the side of boards that might be inclined to support management at the expense of the shareholders.

Second, the shift to multiple-tier common stock could only be accomplished with shareholder approval—either in the form of a vote or in the form of a decision to purchase existing low-vote common stock. If it turns out that the investor is disadvantanged by holding the low-vote stock, that disadvantage will be quickly reflected in the price of the stock. In short, this seems to be a classic case of a situation in which the marketplace can take care of itself.

VOLATILITY OF THE EQUITY MARKETS

Program trading, as we are well aware, the equity markets have been extremely volatile in the past few years. That volatility is, in part, simply a result of the continued institutionalization of the marketplace and an apparent acceleration of the turnover rates in institutional portfolios. The average holding period of a share listed on the New York Stock Exchange is now only 18 months. In the decade of the 1950's it was 6 years.

On balance, I do not believe that the development of derivative products—options and futures—has increased volatility. Rather, it has increased depth and liquidity and reduced risk by permitting much more efficient hedging strategies. The marked shift of individual investors into mutual funds over the past 5 years has made those sophisticated techniques available to everyone.

A special problem appears to have developed with so-called program trading, which involves professionals arbitraging between the equity markets and index-based derivative products, especially in the futures markets, and most particularly, in our view, the Standard & Poor's [S&P] 500. Four times a year, on what have come to be called "triple witching hour" days, options and futures expire simultaneously in the major markets. The result is extraordinary volatility of a kind that no individual investor can hope to cope with—but only for a limited period of time. It should be noted that the 4 days mentioned above are the four expiration dates of the S&P 500. It is widely believed by us that the S&P 500 alone, without the association derivative products, accounts for a substantial amount of the market movement on these days.

This is an extremely complex problem, made more difficult because the use of computer-driven trading strategies makes it difficult for even the participants to change their minds in the middle of executing a plan. It is clear that the volatility on "triple witching hour" days is excessive, although recently the situation has been less extreme. It is also clear that program trading improves the efficiency of the markets during the period prior to unwinding the positions. It is also believed that more than half of the institutional hedging transactions are related to a new practice in the industry called portfolio insurance. Portfolio insurance allows an opportunity for institutional investors to more adequately and flexibly alter their strategy based on short-term changes in market direction. It is not yet clear how difficult it is for professional inves-

tors to cope with these four difficult days. Nor is it clear whether individual investors suffer a significant disadvantage if the better part of wisdom dictates that they try to stay out of the market on that day. Nor do we know whether the market will suffer from a critical lack of liquidity if individual investors stay out of the marketplace on those same days. As mentioned above, it appears that not all derivative products contribute to volatility in the same way, and that activity in the futures markets plays a greater role than does option trading.

My point is that it is too early to tell which is the baby and which is the bath water, and we should be extremely aware of throwing out anything at this point. This is not a case where the efficiency of the market, however, solves all the problems. Regulation has a central role to play. The SEC has been engaged in extensive and detailed discussions with market participants, industry groups and the exchanges, which by the way is a practice they do on an ongoing basis in many areas and, in effect, extend their resources. Some experimentation is going on now. I think that the SEC is the right forum and that it is taking the right approach.

INTERNATIONALIZATION

Let me discuss internationalization. There is no greater challenge to effective regulation than the internationalization of the capital markets. Some people appear to believe that if we adamantly preserve our standards, American investors will be protected. The preservation of our standards is critical; but we cannot put our heads in the sand, telling ourselves that we are protecting American investors, when American companies are financing abroad in markets in which Americans participate—directly or through funds of various kinds. Moreover, Americans and American institutions have become active investors in foreign securities traded abroad. If we want to protect American investors, we must have an active interest in the standards in those markets.

I say that there is no greater challenge to regulation because it is so clear that when the marketplace is broader than the reach of the regulator—which is now the case—regulation is imperfect and the potential for abuse is magnified. Some very significant steps have been taken in the past year. The recent changes in bank capital requirements, which were undertaken in cooperation with the Bank of England, represent a giant step forward. The same is true of cooperative efforts between the SEC and financial regulatory authorities in Switzerland, which were begun some years ago. The Commission now has under consideration various methods of reconciling disparate disclosure standards among the major financing markets.

These are important moves. Much remains to be done. The international tender offer area is one that requires some special attention. The Congress should play an important and continuing oversight role in ensuring that the pace of change is sufficiently rapid and that the SEC is dealing with the full range of issues.

Mr. Chairman, that concludes my testimony. I have not addressed recent disclosures about the use of inside information in connection with merger and acquisition transactions because I do

understand that to be a subject of separate hearings as well. I cannot close, however, without expressing my support for the general approach of the SEC to this reprehensible conduct. The markets will only serve their public function if investors have confidence in the integrity of the marketplace. That is true of institutional, as well as individual investors. The ability of American business to finance depends upon that integrity, as does the future of our own industry.

[The complete prepared statement of Robert P. Rittereiser follows:]

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TESTIMONY OF ROBERT F. KITTERGISER, PRESIDENT AND CHIEF EXECUTIVE OFFICER OF THE E. F. HUTTON GROUP BEFORE THE SUBCOMMITTEE ON SECURITIES OF THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

February 24, 1987

Mr. Chairman, I am pleased to appear before this distinguished Committee to discuss the adequacy of the current regulatory framework in the securities industry. The Congress, and in recent decades this Committee in particular, has been a major force in shaping our industry. In the past, we have been blessed by fruitful discussions among the Congress, the SEC and the industry about the ways in which the securities markets serve the public, the goals of the regulatory system and the most effective way to implement those goals. These hearings continue that fine tradition.

I would like to begin by setting out the general principles that guide my consideration of the questions posed by the Chairman when I was asked to testify:

- The primary goals of the securities industry are to serve investors in investing the savings pool in our economy in an informed and appropriate manner, to raise capital for American business and to participate in the process of making the market pricing mechanism as effective as possible.

- The regulatory system that has evolved over the years, and especially the reliance on self-regulation and a strong capital base that have been the focus of Congressional concern since 1975, is fundamentally sound.

- The search for the perfect regulatory system is essentially the search for balance between governing conduct by rules - - which seeks to forestall undesirable behavior at the risk of stultifying legitimate activity - - and relying on enforcement - - which can be more narrowly focussed on undesirable behavior but runs the risk of constantly closing the barn door after the horse is gone.

- The second balance that must be struck is between the role of government and the role of the marketplace. The vitality and diversity of the American marketplace and the increasing efficiency of information flows to broader and broader groups of investment professionals and individual means that the markets are increasingly able to protect themselves, particularly with the aid of vigorous enforcement. Nevertheless, there is a critical role for regulation to perform.

With that background, I would like to address four developments that have posed major challenges to the regulatory system: greenmail, the one share one vote issue, program trading and the internationalization of the capital markets.

GREENMAIL

Let me begin with greenmail. At the outset, I agree that the possibility of a hostile takeover plays a role in forcing the management of American business to be more efficient. And I also agree that the elimination of greenmail will reduce the number of players in the hostile takeover game. That loss does not, in my view, counterbalance the overwhelming fact that greenmail is fundamentally unfair to virtually all real investors, individual and institutional. When greenmail is paid, the investors' money -- corporate assets -- is used to eliminate a takeover threat. It is a double whammy -- they do not participate in the premium paid to the raider, and their own money is used to pay it.

Moreover, in thinking about whether discouraging some raiders is too high a price to pay, I distinguish between the threat of hostile takeover from another company and a threat which is essentially financial in nature. It is always dangerous to overgeneralize, but I believe that eliminating greenmail will not do much to discourage hostile takeovers that serve strategic business purposes and that the public interest will not lose if some financial raiders are discouraged. As Senator Proxmire recently observed, it is time to get the principal focus of the economy back on business and away from paper transactions.

Finally, it is essential that, in eliminating greenmail, we do not adopt a rule that also eliminates legitimate conduct. Accordingly, I do not support proposals that, following the British model, would require any person acquiring more than a specified percentage of a company's equity -- say 20% -- to acquire the whole company. There may be perfectly appropriate business goals served by owning a minority interest in another company. A better solution, I think, is to simply require that if a company offers to acquire more than a specified percentage of its own shares -- 5% for example -- at a price above market, then the offer must be made pro rata to all shareholders.

ONE SHARE ONE VOTE

Let me now turn to the one share one vote issue. First, it is essential to see clearly what interests are at stake. We are not dealing with a voting right that should be likened to a vote for political office. Investors always have the option to sell a security when they do not like the way a company is being run. The franchise is not widely exercised by investors -- except by institutional investors in the case of "poison pills" and other anti-takeover devices. The principle function served by voting shares is to buttress corporate accountability, and

accountability is generated by the need to face shareholders at an annual meeting, the possibility of a proxy contest and the threat of a takeover Although there are many legitimate corporate purposes served by having two or more classes of common stock, the drive to amend the New York Stock Exchange rules is powered by the desire of American business to reduce the ability of an acquiring corporation in a hostile takeover to gain control.

There are two questions that must be asked in considering that proposal. First, will reduction of the voting power held by investors give the Board the power to perpetuate itself without effective challenge? I think the answer to that question is "no." Unlike most mutual institutions, to which some have pointed as a model for what will happen if the one share one vote rule is changed, American business has a constant need to finance. Thus, market participants, including the rating agencies, analysts, and others in the professional investment community are making constant judgments about the quality of management. Those judgments are reflected in the company's ability to finance and the cost of both equity and debt capital. Moreover, the directors remain subject to their fiduciary obligations to act in the best interests of the shareholders, and the threat of shareholder litigation is, even today, a sharp prod in the side of Boards that might be inclined to support management at the expense of the shareholders.

Second, the shift to multiple-tier common stock could only be accomplished with shareholder approval -- either in the form of a vote or in the form of a decision to purchase existing low-vote common stock. If it turns out that the investor is disadvantaged by holding the low-vote stock, that disadvantage will be quickly reflected in the price of the stock. In short, this seems to me to be a classic case of a situation in which the marketplace can take care of itself.

PROGRAM TRADING

As we are all aware, the equity markets have been extremely volatile in the past few years. That volatility is, in part, simply a result of the continued institutionalization of the marketplace and an apparent acceleration of the turnover rates in institutional portfolios. The average holding period of a share listed on the New York Stock Exchange is now only 18 months. In the decade of the 1950's, it was six years.

On balance, I do not believe that the development of derivative products -- options and futures -- has increased volatility. Rather, it has increased depth and liquidity and reduced risk by permitting much more efficient hedging strategies. The marked shift of individual investors into mutual funds over the past five years has made those sophisticated techniques available to everyone.

A special problem appears to have developed with so-called program trading which involves professionals arbitraging between the equity markets and index-based derivative products, especially in the futures markets, and most particularly the S & P 500. Four times a year, on what have come to be called "triple witching hour" days, options and futures expire simultaneously in the major markets. The result is extraordinary volatility of a kind that no individual investor can hope to cope with -- but only for a limited period of time. It should be noted that the four days mentioned above are the four expiration dates of the S & P 500. It is widely believed that the S & P 500 alone without the association derivative products accounts for a substantal amount of the market movement on these days.

This is an extremely complex problem, made more difficult because the use of computer driven trading strategies makes it difficult for even the participants to change their minds in the middle of executing a plan. It is clear that the volatility on "triple witching hour" days is excessive although recently the situation has been less extreme. It is also clear that program trading improves the efficiency of the markets during the period prior to unwinding the positions. It is also believed that more than half of the institutional hedging transactions are related to a new practice in the industry called Porfolio Insurance. Portfolio Insurance allows an opportunity for institutional investors to more adquately and

flexibly alter their strategy based on short term changes in market direction. It is not yet clear how difficult it is for professional investors to cope with these four difficult days. Nor is it clear whether individual investors suffer a significant disadvantage if the better part of wisdom dictates that they try to stay out of the market on that day. Nor do we know whether the market will suffer from a critical lack of liquidity if individual investors stay out of the marketplace on those days. As mentioned above, it appears that not all derivative products contribute to volatility in the same way, and that activity in the futures markets plays a greater role than does option trading.

My point is that it is too early to tell which is the baby and which is the bath water, and we should be extremely wary of throwing out anything at this point. This is not a case where the efficiency of the market solves all problems. Regulation has a central role to play. The SEC has been engaged in extensive and detailed discussions with market participants, industry groups and the exchanges. Some experimentation is going on now. I think that the SEC is the right forum and that it is taking the right approach.

INTERNATIONALIZATION

There is no greater challenge to effective regulation than the internationalization of the capital markets. Some people appear to believe that if we adamantly "preserve our standards," American investors will be protected. The preservation of our standards is critical; but we cannot put our heads in the sand, telling ourselves that we are protecting American investors, when American companies are financing abroad in markets in which Americans participate -- directly or through funds of various kinds. Moreover, Americans and American institutions have become active investors in foreign securities traded abroad. If we want to protect American investors, we must have an active interest in the standards in those markets.

I say that there is no greater challenge to regulation because it is so clear that when the marketplace is broader than the reach of the regulator -- which is now the case -- regulation is imperfect and the potential for abuse is magnified. Some very significant steps have been taken in the past year. The recent changes in bank capital requirements, which were undertaken in cooperation with the Bank of England, represent a giant step forward. The same is true of cooperative efforts between the SEC and financial regulatory authorities in Switzerland, which were begun some years ago. The Commission now has under consideration various methods of reconciling disparate disclosure standards among the major financing markets.

These are important moves. Much remains to be done. The international tender offer area is one that requires some special attention. The Congress should play an important and continuing oversight role in insuring that the pace of change is sufficiently rapid and that the SEC is dealing with the full range of issues.

* * * * *

Mr. Chairman, that concludes my testimony. I have not addressed recent disclosures about the use of inside information in connection with merger and acquisition transactions because I understand that to be the subject of separate hearings. I cannot close, however, without expressing my support for the general approach of the SEC to this reprehensible conduct. The markets will only serve their public function if investors have confidence in the integrity of the marketplace. That is true of institutional, as well as individual investors. The ability of American business to finance depends upon that integrity, as does the future of the securities industry.

Senator RIEGLE. Thank you very much.

Our final panelist in this panel is Mr. Alvin Shoemaker, who is the chairman of the First Boston Corp. Mr. Shoemaker, last but not least, let us hear from you.

STATEMENT OF ALVIN V. SHOEMAKER, CHAIRMAN, THE FIRST BOSTON CORP.

Mr. SHOEMAKER. Thank you very much. I have submitted a statement for the record that answers the three questions that you've outlined and since I'm the last on the panel I thought that I just would make a few general comments of matters that have been raised that I would like to sort of highlight rather than go back and say some of the very same things that my colleagues have already stated.

INTEGRITY OF THE SECURITIES INDUSTRY

Let me just start by saying that it's very difficult for me to adequately express the amount of moral outrage that I personally have over what is happening to our industry in the way of the criminal element that has taken part in our industry and has caused the integrity of the whole industry to be questioned.

My colleagues and I in the industry have worked very hard to build this into what I think is a very effective and competitive industry worldwide, and to see people who have come into the industry who seem to have no limits as to their greed and to take and steal information for their own personal use is no different than the person who embezzles money from the bank and we hope that all of them are put in jail for a long time.

It hurts the integrity of our industry, but it also hurts the integrity of the marketplace. And the marketplace trades billions of dollars a day based on the ability to deal with an honest yes or no on the other side of the telephone and we cannot have that impugned in any way and I can assure you that our industry will cooperate and do everything possible to make sure that that integrity is maintained.

Two points that I would like to just emphasize, and that is that as we go through the discussions on a lot of these issues that involve the securities industry there is a tendency I think to move several different issues all into the same issue and it's important that we help you frame appropriately what the issues are so that we can then get the remedies that will fix those problems and not indirectly fix one problem and cause several problems in other areas.

It's been mentioned today the need to review the tender and takeover laws and the Williams Act to see what appropriate amendments would be necessary. I think it's important that we look at that in the framework of what is a balance between the need to protect the rights of the shareholder as well as to look at the rights of the management so that there's not an entrenched management on the other side.

Therefore, you've got to look at that set of problems really in a balanced way and make sure that the whole series of suggestions

made come out with a balance that will provide a fair and even playing field so that we have the right results.

It's also important that as we look at the problems of insider trading that we keep that separate from that issue and we look at those as criminal violations which should be prosecuted and ways in which we can disclose information sooner and quicker to the public so as to cut down on the possibilities of insider violation.

Other issues that have been raised by people have been the use of junk bonds. I think the use of junk bonds has got to be looked at in terms of what's the appropriate amount of leverage in a particular type of company or industry and who are the owners of those bonds and whether they are appropriate for them as investments.

Finally, the issues have been raised as to what are appropriate powers for various financial institutions. These clearly ought to be looked upon as a whole separate set of issues.

The last point that I would just like to emphasize, every one of my colleagues has raised the same issue but I think it's one we can't say enough about, and that is the internationalization of the securities markets. When much of the framework of the legal structure under which we operate today was established, it was established with the U.S. capital markets in mind and with a totally different international environment.

Today, as you know, around the world we are trading securities 24 hours a day. Barriers are falling down in various countries and the capital markets are beginning to flow together in a much more unified manner. It will be very important that the SEC be not only encouraged but given every bit of support to make sure that we find ways to regulate that international marketplace, that the United States is not pulled down in terms of the quality of information which we require and the restrictions to other countries' levels, but that we work to bring them up to the highest level.

What you don't want is a regulatory arbitrage which is where people go and find, in effect, the lowest common denominator to operate out of. And I think that's going to be a very difficult task, one that I think you should give a lot of attention and time to because frankly it's one that none of us have really dealt with and the laws were not set up to deal with that problem.

Thank you very much.

[The complete prepared statement of Alvin Shoemaker follows:]

Senator RIEGLE. Well, let me thank all of you. I think in this first round of questions we will take 5-minute time segments just in order to give everybody a chance to participate, and then in succeeding rounds we'll make a judgment as to how long they will be.

I want to draw attention to everybody here in the room that we have on our second panel, three very distinguished individuals who have played major roles in the securities market regulatory side of things over the years, one former general counsel of the SEC, one former commissioner of the SEC, and also a person who headed the widely acclaimed 1963 special study on the securities markets. So next we will have a different panel that in a sense looks through somewhat a different window and it's very important I think, that we have sufficient time during the day to let both panels be heard.

We have related issues that we're soon going to deal with here in terms of what the financial services business of the future should look like with respect to the rearrangements that are taking place in the market between banks and investment houses and people in the insurance business and others generally in commerce and so forth.

INTERNATIONALIZATION DIMENSION

I think the internationalization dimension which seems to be moving ahead at such an incredible rate of speed, where we are now trading around the clock and you have not only new instruments and new places, but new entities. We're going to need to understand that much better I think. I think you, yourselves, are saying this is moving so rapidly it's hard to fully fathom it and you're in the business, so it's even that much more difficult for us.

So as we try to understand those relationships as it relates to the issues we're addressing today and also the future structure of the financial services business in this country, I think we need to exchange information and try to understand those dynamics as well as we can from a national interest point of view.

So we will be calling on you for your thoughts in that regard and I hope you will share them with us to the extent appropriate today or beyond today.

Now, Mr. Shoemaker, in your testimony you state, "It frankly would not disturb me if the SEC's budget were doubled." I'd like to ask you, is that in effect a recommendation? Do you think we ought to consider doubling it? I know it's probably a figure of speech, but I'm interested in the question of whether we need to substantially increase the resources of the SEC so that they can get at these problems that you yourself expressed this moral outrage about.

Mr. SHOEMAKER. Well, I think the SEC has asked for a one-time increase in their budget and my suggestion is that I don't think it's a one-time problem, that we think that the SEC needs more resources. The issues are much more complex and we support—and the industry I'm sure is willing to pay—whatever it takes—and I don't know that I have the number, but the point we wanted to make is that the integrity of the marketplace is so important that the cost must be borne to make sure that it is maintained. And it

STATEMENT OF

ALVIN V. SHOEMAKER
CHAIRMAN OF THE BOARD
THE FIRST BOSTON CORPORATION

Mr. Chairman, Members of the Subcommittee, my name is ALVIN V. SHOEMAKER and I am Chairman of the Board of The First Boston Corporation ("First Boston"), an international investment banking firm headquartered in New York City. First Boston was the first publicly held major U.S. investment banking firm, and First Boston is one of the five firms widely considered as comprising the "special bracket": the group of firms with the greatest origination and distribution capabilities. I have been an investment banker for 18 years and have been Chairman of the Board of First Boston since 1983. I appreciate the opportunity to appear before the Subcommittee to discuss current issues in the securities markets and the role and performance of the Securities and Exchange Commission ("SEC"). Mr. Chairman, in response to your letter inviting me to present my views, I will confine my opening statement to the three specific questions you raised.

The first subject you have asked me to address is the role of the SEC and the role of self-regulation in the securities market. The pattern of laws which defines the U.S. capital market, and the roles of the participants creates a careful balancing of the national interests in the efficiency of the market, in fairness to the investor and in the absence of market manipulation. The federal securities laws have operated to balance these sometimes conflicting interests: the individual

investor versus the market-maker; ease of issuer access to domestic and foreign markets versus proper regulation to prevent market manipulation; market participants' interest in laying off of risk by using derivative instruments versus avoidance of volatility in the market; and the underwriters' need for aggressive risk-taking which creates free and open competition versus the market's need for broker-dealer fiscal integrity. It is these principles embodied in our securities laws which also mandate the relationship between the SEC and the self-regulatory organizations ("SRO's"). For example, while overregulation can impede the efficiency of the market, fairness and the integrity of the market demand that information be disseminated to all participants. If regulation of the markets is weighted too heavily towards market efficiency, investors and the integrity of the market suffer. But if the regulation is so intent on preserving fairness and preventing market manipulation that it constructs artificial barriers to market access, there is no market. The ideal, then, is an appropriate balance which achieves all of these goals and assures that our market works.

Before you suggest that I merely state the securities law equivalent of platitudes, I want you to understand this balancing of interests is central to my renewed faith in the genius of the design of the '33 and '34 Acts and other laws such as the Glass-Steagall Act. My basic philosophical slant, bolstered by my

experience, has been towards a free market and up until the last year I had begun to favor increased deregulation. Recent events, however -- bank failures, government securities dealers failures, and the insider trading scandals -- have led me to recognize that the securities laws, like the Constitution, state principles which evolve and meet changed circumstances over time. Reliance on enduring principles is the only mechanism to accomplish the basic and essential balancing of interests despite dramatic changes in the technology, instruments, volume and basic nature of the market.

The internationalization of the capital market presents a particularly good example of a difficult challenge which our laws and regulatory system must meet now that the flow of capital and information can be instantaneous. This phenomenon presents a new balancing of interests which must be incorporated into our regulatory system: the ability of the U.S. capital market to remain competitive globally versus the importance of the high disclosure standards which are unique to our system. This challenge must be met not only by the coordinated efforts of the SEC, the exchanges and the industry but also through international cooperation. It is vital to our national interests that the flow of capital be determined by economic factors and not by differences in regulation and that the U.S. market not become outmoded due to regulatory impediments. Otherwise, the U.S.

capital market becomes the victim of "regulatory arbitrage" where forum-shopping for less restrictive regulations overrides market forces. This, of course, must be done without impairing our traditional commitment to investor protection and disclosure. The SEC and the SRO's in cooperation with the industry are currently involved with the immediate need to address this challenge. I merely stress a coordinated effort is essential.

In determining the appropriate form of regulation, the structure of our securities laws requires that the strengths of government regulation be weighed against those of self-regulation, and this balancing determines the role of each. The value of self-regulation is the sensitivity that comes from constant involvement in the market process. This enables SRO's to identify and address specific problems, such as suspicious trading activity, as well as broader policy issues such as the coordination of our markets with international markets. Their proximity to the markets ensures more effective and swifter reactions to market developments. It also enables the industry to govern efficiently its practices. It is then the role of the SEC to police inherent conflicts in the industry and the industry's place in the nation's economy through its enforcement powers.

The concept of industry self-regulation combined with direct governmental supervision remains valid: a vigorous and watchful

SEC coupled with the hands on, daily contact of the SRO's with the market. It has provided stability and, thus far, continued investor confidence despite the recent failures of thinly capitalized government securities dealers and severe insider trading scandals. While deregulation is appropriate in some instances, we cannot allow erosion of investor confidence or any weakening of the integrity of the market and our system of fairness and disclosure.

You have also asked what, if anything, the SEC should be doing under its present authority which it is not doing and whether there are any improvements to be made. The SEC does an outstanding job in carrying out its duties with great diligence and competence. I believe that it has demonstrated efficient use of its resources and continues to make a significant and necessary contribution to the stability and integrity of our capital market.

Regulation of the securities market can always be improved. In a system as dynamic as the global capital market, change is usually progress, if carefully crafted and implemented. I have already addressed the need for the review currently under way of the meshing of our regulatory system with the global capital market.

Further, I believe you must address the increasing volume of securities activities of banks, even in the absence of new

securities powers or creation of legal loopholes to circumvent the spirit of the law. Commercial banks are allowed to engage in certain securities activities -- either because the specific securities are not deemed to pose significant risk or because the bank's role is severely limited to preclude conflict of interest or safety and soundness problems. Despite such limitations, banks are a notable, yet unregulated, presence in the market. For example, banks were permitted to offer their customers money market accounts at competitive interest rates in December of 1982. Six weeks later, deposits in these accounts had reached $213.2 billion, exceeding the total assets in all of the nation's money market funds. Banks have also become major dealers in securities of GNMA, FNMA, and FHLMC as well as in certificates of deposit, banker's acceptances and Eurodollar securities, and are major underwriters of general obligation bonds of states and political subdivisions. To say that banks are precluded from securities activities or the ability to compete because of the strictures of Glass-Steagall is simply not true, especially since they benefit from the Glass-Steagall exemptions from regulation.

The securities laws are replete with exemptions for bank securities activities. Banks are not regulated, unlike every other broker/dealer in the United States, by the SEC. The Commission itself has obviously recognized this gap in its authority by the promulgation of Rule 3b-9 to subject banks or

their subsidiaries engaged in broker/dealer activity to SEC regulation. The vehement opposition of the American Bankers Association to this rule and, indeed, to any assertion of SEC jurisdiction over bank securities activities should indicate to this Subcommittee that there is a gaping hole in the only regulatory scheme created for the protection of investors. In my opinion, regulation of such activities by bank regulators charged only with the safety and soundness of the banks ignores the goals of the securities laws to protect the market and the investor.

Your last question is on the adequacy of resources and remedies of the SEC. My impression, which I believe is shared by many of my colleagues in executive management on Wall Street, is that the SEC does not have sufficient resources to accomplish the task mandated by Congress, particularly in view of the burgeoning securities industry. My impression of the SEC's performance, which I again believe is shared by my colleagues, is that the SEC is doing an excellent job in applying the resources they have been given to accomplish this mandated task. While I am encouraged by the request in the President's Budget for increased funding for the SEC, I do not think a one-time 26% increase will prove sufficient. The SEC's resources must keep pace with the dramatically increasing activity in the securities market. The SEC must have not only the technological resources to match market advances but also the human resources to make use of the

information assembled. The SEC is financed by fees paid by the industry -- First Boston would not object to paying more for a larger staff and more technological resources. It frankly would not disturb me if the SEC's budget were doubled -- that is the level of importance I attach to the role the SEC plays in the market. Pervasive SEC activity provides the most effective deterrent to malfeasance and is a key factor to investor confidence in the markets.

As to adequate remedies, the SEC must have the ability to engage in international cooperative efforts to better align the global market. The SEC has only recently been able to penetrate bank secrecy laws in other countries to pursue those who seek to avoid our laws; this is the benefit that flows from international cooperation. The U.S. must be able to take a leadership role in determining the future of the global capital markets so that the U.S. market is protected.

Mr. Chairman, I appreciate the opportunity to testify before you today and present the views of The First Boston Corporation. As usual, the securities market today presents challenges for the regulatory system. I believe the Congress, the SEC and the industry can respond to these challenges, and First Boston looks forward to working with you and your colleagues to that end.

would appear to us that there is a need for more resources in the SEC.

Senator RIEGLE. Do the others of you share that view?

Mr. RITTEREISER. Yes.

Mr. MARRON. Yes. I would say that we're clearly in a technology escalation war where the resources of the marketplace are being strained by the big increase in volume and the globalization and for the SEC to stay even it needs to have all the resources possible.

Senator RIEGLE. So you would favor a significant increase in their resources, Mr. Marron?

Mr. MARRON. It's also a challenge to make sure that the technology component of the SEC surveillance and EDGAR get a very high priority.

Senator RIEGLE. Mr. Mason.

Mr. MASON. My reaction to that would be that you can only expand any agency or anything so rapidly. I think the comment that I made on that was that I think, at minimum, the request of Chairman Shad should be met and if they would be liberalized I don't think that would bother any of us. It would make more sense maybe to do that over a period of years versus 1 year because of just practicably being able to handle it.

Senator RIEGLE. Mr. Rittereiser.

Mr. RITTEREISER. I would agree with the statements. I do think the expansion has to be managed. There probably are some new skills that have to be developed, including analytical skills, which would build on the use of the computer equipment and other systems that are being developed.

Again, I think the SEC working with the industry can reach out and use some of the resources and help us—we can design some of our reporting systems to be helpful to that task as well to minimize the need for excessive increases in the budget long term.

SELF-REGULATION OF THE INDUSTRY

Senator RIEGLE. Let me pose now a basic question to the four of you. This debate as to the degree which self-regulation can really do the job to deal with the kinds of problems that we're seeing, versus the degree for more governmental effort through the SEC, changes in law, what have you.

I'd like to hear from each of you as to what you think is needed specifically in each area. I realize in some cases this is a bit of a recap, but I'd like to know specifically on the self-regulation side, what should the industry itself be doing to deal with this problem that is properly within its domain and that the Government could in effect count on the industry to get that part of the job done and then I'd like you to be specific about the specific additional items of initiative that you think the Government needs to take so that we see to it that our job gets done. If one of you would like to start first, we'll start with that person.

Mr. Rittereiser, you look like you're ready to comment.

Mr. RITTEREISER. I want to be sure I understand the question. First and foremost, I would say that to a great extent we are talking about industry managing the control function of its business better than it has in the past or constantly looking to improve it.

Recently, the New York Stock Exchange proposed a set of additional steps which in fact reinforce the control obligation of management and to a great extent build on practices that exist in the business and, if carried out again more effectively and reported on perhaps more effectively, we probably would have detected perhaps—I think there would have been a better chance to detect some of the problems that have since come out in other ways.

I think the industry's self-regulatory mechanisms are really quite good. All of us have participated over the years in that process and in many cases I think the industry has been tougher on people that they have detected early than—and these are things people don't hear about—they have been tougher than any external regulatory agency would be. And people do know that there was a sense of concern and control in that area.

I would build on those reporting systems and those self-regulatory mechanisms and I would encourage the SEC to be even more active perhaps in planning what they need to receive from that.

As far as the role of Government, I think these issues like internationalization and behavioral standards tend to get dealt with in the market structure issues that have to do with things like how will we supervise participants in the market, what are the capital standards, what are the reporting standards. So that the decisions Congress ultimately makes—and I believe Congress should make them—about the structure of our industry, who can compete in it and under what conditions, both domestic institutions and foreign institutions will determine the outcome of the so-called quest for the level playing field. These competitive issues are primarily disputes between domestic institutions but the Congress must take into account who the foreign competitors are going to be and under what ground rules will they be permitted to participate in this market. And I would look for Congress to spend a good deal of time in that area.

Senator RIEGLE. I realize I posed a very large question and my time is up. I do want you to answer, though, and then we'll try to make the adjustment down the line. Mr. Shoemaker.

Mr. SHOEMAKER. Well, I think that most firms on Wall Street have reviewed their own internal procedures for handling most of the use of inside information. Well, 8 months ago we brought in outside law firms to audit all of our procedures to see how we were handling them, to see what we could do to improve upon the manner in which we were running the firm, and we made quite a few changes.

From what I know of the New York Stock Exchange workings, they have also been going through this same rigorous review to see what did we do wrong, what can we do to improve it. You'd have to have been asleep with all this publicity not to be very concerned about how you're operating.

So right now the industry is spending a lot of time in self-examination trying to resolve and come up with better ways to control some of the flows of information and these complex issues.

Now where the SEC I think can be very, very helpful and it is very difficult, we can set procedures, we can do a lot of things to improve the way in which we run these firms, but there is always that 1 percent element out there of somebody—whatever it is—that

is going to do something crooked, and it is very difficult to catch these people because they obviously aren't going to tell you what they're doing.

So we do need help frankly—we do need Government help to help us root these things out. So there is a place in both self-regulatory and self-analysis, as well as for the Government in trying to reduce these problems.

Senator RIEGLE. Mr. Marron and Mr. Mason.

Mr. MASON. Well, I guess that this is caused by lots of things obviously. I mean, I have to admit with the comment made earlier, I've been amazed—shocked and amazed particularly the past couple weeks.

Relating to your issue specifically, I think there are several factors that come in. There are issues that Congress has to decide. There are issues that the SEC must oversee and decide, and there are issues that the self-regulatory side is, in my opinion, better equipped and prepared to handle.

CONGRESS NEEDS TO ACT

The issues that I think are before us right now that are critical, some of which are in Congress' hands, obviously being Glass-Steagall. Congress has moved away from this for some time. It is, in my opinion, probably a major factor in what's gone on overall and we cannot allow it to be stripped away. It must be resolved as an issue and not in pieces. I think it will do incredible damage to this industry and others if we don't do it that way.

Two, involved in this same issue, it is obviously absolutely critical that we retain the integrity of our markets and one of the things that concerns me the most—and I think that maybe we can now go back and look at—is that we make the decisions in the future on what is best for the markets and not as what you can do with the markets. A lot of decisions that have been made in areas that you all are dealing with, such as the various forms of options and program trading and things of this nature, are decisions that were made on things that you could do within the market before the decisions were made as to what that would do to the market, which I frankly think is an issue that the SEC should be dealing with.

Third, I think that if we make sure that we retain our original goals which they were for years, that the role was to protect the public investor.

If we get those three issues in mind, I think we can then go about solving the issues. I think that when we talk about the self-regulation issue in and of itself, I think that the New York Stock Exchange in general and the NASD in general, if not in specific, have done an absolutely super job on their side. I think there are issues such as internationalization of the markets.

The SEC must be the one to regulate that.

The risk here again is that we are going to end up with two and three regulatory sides, that the banks will be regulated one way and the securities industry will be regulated another way, and that will cause immeasurable damage, both domestically and internationally. And, you know, the concepts about equal regulation, as

long as each agency in that field regulates, I agree with it. You start dividing, and I think we are going to make the issues worse.

I think the oversight that the Congress has of the SEC, and the SEC has of the self-regulatory bodies, particularly such as the NASD in New York and other—the American—I am not trying to slight any other group, has been critical and important. The one factor that has, I think, been very helpful within this industry and unique to this industry, has been that you have people that have substantial understanding of an issue and can move on the issue immediately.

You don't have to sit down and teach them, coach them, work on it, go through it. They understand immediately what the problem is, and they can sit down in a hearing or on issue and work it out rapidly, because of their understanding. They are not serving on a staff for 1 year or 2, and in my view, this has been very helpful to the Commission. It has been incredibly helpful to the industry, and I think the industry has always been willing to be very helpful to Congress, whenever asked.

Senator RIEGLE. Mr. Marron, just very briefly, if you can.

Mr. MARRON. Yes. There are three issues, really, that we are dealing with. Information, management, and laws and regulations.

And information, I feel we need more. It needs to be communicated better and faster.

In terms of management, that is where the self-regulatory organizations can help, in helping us redraft rules that reflect the problems of insider trading and the realities of the more complicated markets.

In terms of laws and regulations, you have two issues there. You have, how do you deal offshore. There is no way any of us can do that individually as firms or even as self-regulatory organizations. And second, how do you define clearly, when people go over the line.

I think those are the issues that need to be addressed.

Senator RIEGLE. We will come back to some of these. Senator D'Amato.

Senator D'AMATO. Mr. Chairman, first, I think the panel should be commended for coming forth today with some very explicit suggestions as to how to deal with some of the problems and not just simply taking the position that all is well, because all is not well. I think particularly Mr. Marron and Mr. Rittereiser's comments, on the adverse effects of greenmail are forceful arguments supporting the restrictions of greenmail payments. I think their comments with respect to closing the 10-day window or at least shortening the period of time, deserve our consideration.

FOCUS ON TROUBLES AND CLARIFICATION

I also believe it is important that we focus in on a better definition of inside trading, and I would like to ask if Mr. Marron, Mr. Rittereiser, Mr. Shoemaker, or Mr. Mason whether such a definition should be considered. We all understand the Levine-Boesky situations. They speak out for themselves. There is no definition needed there.

But where do you find troubles? And my question is, where do you find troubles with the current status of the law on insider trading? Could you give us an illustration of where you find some difficulty and why it is necessary for us to come forth with a clarification.

Mr. MARRON. I will give you one that I think is probably academic but would make the point. We all know that if somebody buys a stock, because they know there is going to be a tender offer, that that is illegal, if they do it in advance of everybody else. But supposing you have two companies in the marketplace in the same business, whose stocks go up and down together at the same time, and when one stock does well, the other stock does well. There are many examples of that in the marketplace, and supposing somebody knows that company A is going to be taken over at a much higher price, but recognizing that is insider trading, they decide, instead, to buy company B. Company A gets taken over. The stock in company B responds and goes up.

Is that insider trading?

Senator D'AMATO. What is your opinion?

Mr. MARRON. I think it is a very close call, because there is nothing absolutely certain about that relationship, but on the other hand, let's say that is a case where 90 percent of the times it happens.

I am picking that one, because there are all kinds of shades of gray. It would be the same thing if you knew that a military contract was giving a giant order to one company. You couldn't buy the stock, if you knew that. On the other hand, if you knew that that company bought all its supplies from a second company when it got a big order, if you bought the second company, is that insider trading?

Now I am picking kind of abstract things, but that is the kind of stuff that we have to deal with in our industry all the time.

Senator D'AMATO. But these are real everyday situations that take place in the industry, and so as we move from the very clear-cut case, there are these other cases that give you cause for concern.

Do you all agree that there should be a better definition of those activities which should be considered as insider trading and illegal? Mr. Rittereiser?

Mr. RITTEREISER. Yes, definitely.

Senator D'AMATO. Mr. Shoemaker?

BETTER DEFINITION OF INSIDER TRADING NEEDED

Mr. SHOEMAKER. Well, we agree with the principle. The problem though of coming up with the definition may be——

Senator D'AMATO. Well, I worked on that for 1½ years and was assailed by every group.

Mr. SHOEMAKER. And I think it is a very difficult principle to come up with.

Senator D'AMATO. Well, we are making progress. In 1½ years, we take Boesky-Levine, and we finally get to the point where we agree maybe we need a definition. Mr. Mason.

Mr. MASON. I would agree that the definition is necessary, because just the very simplistic side of the question that always come up about—suppose—I mean, you get this from the public just in conversation, particularly, recently, suppose I hear a comment from somebody at a cocktail party. Is that insider trading? Suppose a friend calls me that works at a place and gives me information. Well, for me to define that is fairly easy from being in the business, but the public is totally lost in these areas, and they are things that probably occur daily.

Senator D'AMATO. It seems we ultimately must decide whether we are better served by a statutory definition or leave such determinations to be considered by the courts on a case-by-case analysis as some have suggested. A statute alone will not eradicate insider trading, only the concerted efforts of the industry will.

Mr. Chairman, there is another question I would like to raise, and that is, should a securities firm be barred from engaging in arbitrage activities, if it is also acting as an investment banker to a company involved in a takeover?

Donald, do you care to answer?

Mr. MARRON. Well, I don't really. I am not thrilled with that question, Al, but I will try to answer it. [Laughter.]

I think, first of all, without——

Senator D'AMATO. By the way, if you want some time to think about it, go ahead—but some have suggested the enactment of such a provision. What do you think?

Mr. MARRON. Well, I think, first of all, the way the industry has gone, the reality is that firms have to be bigger and bigger, in order to be competitive, not just with each other, but in the world marketplace. As you all may know, the market value of the largest Japanese firm is close to 10 times larger than the largest American firm, to put that in scale. So that the notion that any of the larger firms can go out of one business, I don't think is very practical.

On the other hand, clearly, if you get abuses, you get pressure to create higher and higher and better and better Chinese walls. There are examples of that in specialist units owned by member firms that have to be isolated more than other businesses. And I think it has to be looked at. And as I said in my testimony, I think that is one thing that the exchanges have to look at, but at the same time, if you reduce the ability for us to be competitive, it isn't just the question of a domestic issue, it is the world issue of this country and the globalization of securities.

Mr. SHOEMAKER. One of the problems with the area is that the term arbitrage has been badly misused, because arbitrage generally relates to taking positions in a known transaction where it has been announced, and you then look at the difference between the two securities, and you arbitrage it, or you arbitrage between two different types of securities or between two different marketplaces. Those kinds of transactions are an integral part of the marketplace and generally should not be a problem.

The problem that is generated is that much of what has been called arbitrage over the last few years is nothing more than rumor speculation, and therefore, as you get over into those kinds of activities which Mr. Boesky was involved in in most cases, that is not really true arbitrage. That is just speculation. And there,

when you are beginning to get into taking a position, because you anticipate somebody making a bid, I would suggest that there are areas where obviously, it is totally inappropriate, but that is not really an arbitrage. That is speculation.

So I think we have to be very careful what we define by the use of "arbitrage."

Senator D'AMATO. Should a firm be held accountable or liable, financially, if it knew or should have known that one of its employees was engaged in illegal activities? I think it should.

As you know, I have introduced legislation to hold the firm accountable, if it should have known that one of its employees is engaged in a particular course of conduct. And by the way, it is similar to the money laundry legislation, where we hold other financial institutions accountable for the actions of their employees, if it had reason to know or should have known they were engaged in illegal activities. You must face these issues sooner or later.

Mr. RITTEREISER. Oh, I understand. As a general guideline, I believe that the judgment there should be made on the basis of whether or not management did act in a prudent manner. If management did things, either had an obligation to follow certain procedures, reporting requirements or the like, put intellegent procedures in plan, and generally speaking and very specifically, did follow those procedures, it is fairly clear that management had an intent to comply with the legislation or with the requirement.

It is still possible that an employee or somebody——

Senator D'AMATO. Well, we know that. Somebody could be in the basement. We are saying, if you had a reason or should have known, should a firm be held accountable?

Mr. RITTEREISER. If they have had good procedures and have been prudent in following those, I do not think they should be held accountable, otherwise, I think they are probably liable.

Senator D'AMATO. Mr. Shoemaker.

Mr. SHOEMAKER. Well, I think the same analogy I used earlier. Are you going to hold the bank president liable for the guy who opened the cash drawer and stole money?

It is, again, a question that is raised as to whether the management operated in a prudent manner. And if you want us to be policemen, then you will have to give us some policing powers too. Do you want us to wiretap the employees' phones? These are all questions of degree, of how far you want to go to hold us accountable.

Senator D'AMATO. Donald.

Mr. MARRON. Well, I think that, certainly, if a firm has procedures in place to supervise and it doesn't follow the procedures, there is an element of responsibility there. I hate to say this, but I think, beyond that, the world has gotten so much more complicated, it may be that the self-regulatory organizations have to give us clearer rules on some of these things or clearer mandates. I think with those, you will both improve the surveillance, and at the same time increase the responsibility of the management of securities firms.

Mr. MASON. On your first question, I would say that the role of arbitrage, or what I would describe as risk arbitrage, which I think is where you were going, I think it is difficult to be involved in a

merger and take a proactive role in risk arbitrage. I think that is something that is going to have to be looked at very hard, which, I think, gets more to the heart of where you were going.

In regard to the issue you raised in the second phase of it, that is a much tougher issue, unless you know what the definition of the rule is. I mean, I would rather use a bank president, whose bank made loans to Brazil and Argentina, is he responsible for those loans? It is a much tougher call. And where do you come out on some of issues as to who you can hold accountable for what?

Senator D'AMATO. That is a good response to questions properly raised at another forum, when we address the merits of Glass-Steagall. [Laughter.]

Mr. Chairman, I know I have run over my time, and I thank the chairman.

Senator RIEGLE. Thank you. And I set that example, initially, by asking a very, very complex question as my time was expiring. I will try not to do that again.

Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman. We hear a lot of discussion around here, gentlemen, about Glass-Steagall, and usually, those from your industry are strongly in favor of it. I am not sure I disagree with that view, but we are also hearing now from some of the banking interests who say, well, now, you put Glass-Steagall on us, to divorce investment banking from commercial banking. Why shouldn't investment banking houses be barred from arbitrage activities?

BREAKDOWN OF THE CHINESE WALL

I guess my question, to follow up a little bit on what Senator D'Amato said, is that we have seen a great number of instances now of the breakdown of the so-called Chinese wall, which is supposed to separate the various financial service functions. But realistically, is it really possible, in your view, to preserve the Chinese wall, given the multidepartment firms that we have now with traditional underwriting going on, junk bond underwriting, mergers and acquisitions, leveraged buyouts, new product creation, venture capital investing, securities trading and arbitrage, all operating under the same roof, from the same pool of capital?

Can we realistically believe the Chinese wall will continue to operate? I would like to get your reaction to that.

Mr. SHOEMAKER. Well, I think it can be done, but it is not an easy task, and it makes management's job much more complex, but again, when you operate with inside information, information should only flow as far as there is a need to know. This is one time in which you have to go against what other instincts you might preach in an organization about teamwork, cooperation and letting people know what you are doing, and you have to make some very fundamental judgments as to who needs to know, in order to get the transaction done and complete.

I think in most cases we handle—not most, but we handle these things on a basis, routine basis, I think, very, very well, and there are relatively few breakdowns or poor judgment in the process.

The area of arbitrage, which is the one which you really are centering in on, I think if you go back again to the response that I gave to Senator D'Amato, and you separate out rank speculation and rumor mongering away from the legitimate arbitrage process which makes the capital markets flow, it is what keeps securities in line. It is what keeps markets in line, which closes the gaps where there should be gaps—not gaps in terms of relative values, I think these are all legitimate market functions which we perform as part of our role.

But when you get to the area of people speculating on inside information or where they are advisers, clearly, I think we all should be sensitive to those problems, and if there are answers on how to eliminate that kind of speculation, then we should take specific action. But I don't think that because there have been violations in those areas, that the Chinese wall doesn't work very effectively, because I think it does.

Senator SASSER. Does anybody else want to amplify on that?

Mr. MARRON. Well, I would just add that it is clear that the industry has gotten more complex. There is no question about that. What you are talking about, in part, is the potential for conflicts of interest. I would submit that one of the roles of management in managing a complex organization is to be aware of that. I mean, this industry faced that 50 years ago, when it had to represent both the buyers and sellers of the same security. Who do you represent better? I think everybody would feel you represent both sides equally well. That is why the market works so well.

So I think what you are really talking about here is the value of an institution, of an organization and the capital and the people values that go with a complex organization or the alternative, as implied by your question, of breaking it up into little pieces.

I would argue that the value of the complex organization in today's financial world is the most important value, and that the responsibility is to manage it well and to regulate it properly,

Senator SASSER. Gentlemen, one of our other witnesses is going to testify in a later panel, to the effect that the Securities and Exchange Commission had a staff of 1,711 people in 1941, and here in 1986, we find they have a staff of 1,898. That is an increase of about six people per year, since 1941. I suppose my question would be, is the SEC, in your view, staffed up enough to handle the job, given this complex, high volume market that we have been dealing in in recent years?

Mr. MARRON. I would give a resounding no to that, that if you just look at the increase in volume or the increase in the number of markets or the increase in the number of employees in the securities, or the increase in the number of clients, obviously, it has been dramatic, and the SEC is strained, and it needs more resources.

Mr. SHOEMAKER. It is not just a numbers game, though. It is also one of—I think Don touched on it earlier. It is one of having the proper expertise within the SEC, as things begin to change, both in the area of technology and the expertise in international capital markets and the emphasis that will be required, so that it is not only a question of more people, but it is going to be a question of

getting the right people on the staff that probably wasn't necessary in the past.

Mr. MARRON. And I would just emphasize this computer activity. The whole market is being more and more influenced by computers. And the SEC can't possibly understand that, unless they have an equal kind of resource to analyze and understand what is going on.

Senator SASSER. Mr. Shoemaker, you were understandably agitated a moment ago in your testimony about the abuses of insider trading, and you stated that insider traders should be prosecuted to the fullest extent of the law. But to date, the most severe jail sentence for insider trading has been a 2-year sentence imposed on Mr. Levine.

SEVERITY OF PENALTIES

Do you think more severe penalties. criminal penalties, would have a chilling effect on insider trading? Would that be helpful or not? I was reading in the newspapers that one of the defendants was led from his investment house in handcuffs, and that seemed to astonish all of his colleagues there and seemed to have a very frightening effect on some of them, not that any of them needed to be frightened. I don't mean to tar them with the same brush as this defendant.

But is there a feeling in the investment business that perhaps you can engage in some of these activities and get away with maybe a hand slap or only a light penalty, and would severe penalties be useful?

I am not in favor of just imposing penalties that are long jail sentences, if they won't serve as a deterrent.

Mr. SHOEMAKER. I think there are two different issues here, and one is the question of whether the penalty that was imposed on Mr. Levine and others was appropriate, and I can't second guess the people who are investigating and prosecuting the case, as to, you know, what they thought was appropriate, in order to entice other people, to get other information, to catch other people. I guess that is a subjective judgment as to how much you penalize one person, in order to get information to get other people. I am not in the criminal law business, but, you know, I could answer and just say the more the merrier. But that is a judgment that the prosecutor has to make.

My feeling is that, generally, if you want to talk about a chill, from what I gather, when that individual was handcuffed and taken out of the trading room, it chilled the entire Wall Street area in about 2 minutes, because you had several people on the telephones all over the Street.

So I don't think it is the degree of the penalties. I think if the effect is to shake people up and chill them, I think you have reached it. But the problem that we face, generally, is that, you know, we are at the tail end of a long bull market, and we don't have a lot of people who have been through bad markets, who have only seen things going up. And there are a lot of people who simply don't have the fundamental values in place that they should have.

I've got to believe that this has poked a hole in a lot of people's balloons.

Senator SASSER. Anybody else want to comment?

Mr. MASON. I think he is dead center.

Mr. RITTEREISER. The environment is one that has made people very, very much aware of their responsibilities, and everything is subject to question. Things that people trusted, had confidence in are again being reexamined very vigorously, and Mr. Shoemaker commented earlier about review of his procedures.

All of that was done instantly in our firm, and I am sure, in other firms, right from the outset. And we have all made changes I am sure.

Mr. MARRON. I think that it is safe to say this is an enormous shock to this industry. It is an industry where you don't have to steal in order to do a good job. We all are redoubling our efforts to make sure it doesn't happen.

Senator SASSER. Gentlemen, my time is up. Thank you, very much.

Senator RIEGLE. Thank you, Senator Sasser.

We increased your time to 10 minutes, as well as for the remainder of the members to try to even things up a little bit.

Senator SASSER. Thank you, Mr. Chairman.

Senator RIEGLE. Senator Armstrong.

Senator ARMSTRONG. Thank you, Mr. Chairman.

Mr. Marron, along with others on the panel, you have indicated that you are concerned about the uncertainty, the gray areas in defining insider trading.

Does your firm have a house definition of insider trading?

Mr. MARRON. I don't think that we have a written house definition. We obviously regularly consult with inside counsel and also outside counsel.

Senator ARMSTRONG. I want to come back to you in a moment and ask you to tell us what you think insider trading is, but could I just ask, do the other firms have a written definition that they use for internal purposes?

Mr. RITTEREISER. We don't have a definition. We have a statement of it, in effect, being an activity that is not permitted—we have a statement saying that, in effect, the employees are not permitted to trade or use information that is private or they have a fiduciary obligation on, and words to that effect in our statement of policy of employee trading rules.

Senator ARMSTRONG. Do other firms have the same, Mr. Shoemaker?

GENERAL DEFINITION OF INSIDER TRADING

Mr. SHOEMAKER. We have a general definition of insider trading.

Senator ARMSTRONG. You have a definition?

Mr. SHOEMAKER. Yes.

Senator ARMSTRONG. Would you be kind enough to send me a copy of it?

Mr. SHOEMAKER. Yes, I would be glad to.[1] I am glad I don't have to give it to you now because I don't——

Senator ARMSTRONG. Mr. Mason?

Mr. MASON. I am pretty sure it is in our procedures manual, but I can tell you that I know that the surveillance system that we have in our own computer system codes trades from every broker on a daily basis, which identifies anything that we think could involve insider trading. I suspect other firms have that same kind of a system.

Senator ARMSTRONG. Mr. Mason, what is insider trading, then, for that purpose?

Mr. MASON. Well, any activity in any stock that we see excessive volume in or anything that relates to an issue where there is excessive volume, then it would be coded, and it would come up in that account or related to that broker, so that we could look at it and see if we see anything, and then the only thing you can do is physically make a call, why are you buying the stock or what is going on.

I don't know how else you could, other than your system——

Senator ARMSTRONG. That goes to the technique of spotting trades that would run afoul of the rule. But let's suppose you see that.

Mr. MASON. Well, you immediately go in.

Senator ARMSTRONG. What standards do you apply? Let's suppose that all of a sudden a broker who has never done business in Jones Manufacturing, suddenly develops a great interest in it, trades very actively in it, and you call him up and say, "Why are you trading in Jones? Are you an insider?" And he says, "Well, what do you mean by that?"

Mr. MASON. Well, I think our definition within the industry is probably much broader than the definition that—I mean, it is a lot clearer than most other people.

Senator ARMSTRONG. Would you state it? It is not clear to me, and I don't think it is clear to the committee.

No, let Mr. Mason go ahead. I am not trying to lead you into water you don't want to get into.

Mr. MASON. But you are. [Laughter.]

Senator ARMSTRONG. I am a young broker. I am a broker who has just been trading all this Jones stock, and I turn around, and I say, "Mr. Mason, gosh, I didn't know that. What is it I am not supposed to be doing?"

Mr. MASON. Well, I would find it difficult to believe that many brokers would not understand the difference between when they were an inside trader or not. And, if in our opinion as a firm——

Senator ARMSTRONG. Mr. Marron said it was difficult.

Mr. MASON. Well, it is difficult, particularly when you get outside the industry. It is substantially less difficult—I would find it is hard to believe it is not a lot less difficult inside the industry than it is outside the industry. If we found that a broker was dealing in a stock that, in our opinion, involved insider trading, we would release him.

Senator ARMSTRONG. Would you just state, though, what the definition of insider trading is.

Mr. MASON. It would be hard, because it could be defined 15 ways. You would have to give me the situation and what happened, and how it happened? Is it a takeover? Is it a call from a third

party? Does it involve institutional buying? It could be five and each of those have a—you know, could all be insider trading.

I can't give it to you, specifically, because it doesn't come at you specifically.

Senator ARMSTRONG. Mr. Rittereiser.

Mr. RITTEREISER. I would just simply comment that in an ongoing review of our business, we look and examine every day, unusual activity, what would be a broader definition of unusual activity. Now that definition really derives from not only the very basic of inside information, if somebody were to be trading on pure inside information, but people trading in securities that, in fact, the firm may not be recommending, or solicited in areas where we are not currently or not expecting to be soliciting orders. So the call from our compliance department to the account executive would go along the lines of, this is unusual activity, tell us what the basis is for your recommendations. It doesn't appear to be in line with what we are recommending. And when we investigated it and found, for example, if, in fact, we found that at that point he was trading on information provided by an insider, we not only would take action against him, but we would report that action.

He has already been trained in what is technically inside information in the course of his becoming registered to deal with our firm.

Senator ARMSTRONG. In other words, this is part of their regular training?

Mr. RITTEREISER. It would be part of the ongoing training and part of their qualification.

Senator ARMSTRONG. Would you be kind enough to send me a copy of the manual or the syllabus of your course that deals with that?

Mr. RITTEREISER. We would be happy to do that.

Senator ARMSTRONG. May we ask that the other firms do the same.[1]

Then, Mr. Marron, back to your point. You stated that if a dealer or broker knew that there was a tender offer coming, and then did business in that stock, that that might constitute insider trading.

Mr. MARRON. It would constitute insider trading, absolutely, unequivocally.

Senator ARMSTRONG. Well, would it, or would it only if he was, himself, an insider, if he had some kind of fiduciary relationship?

Mr. MARRON. Well, I will give you our definition. First, if I can say, Senator, we who have grown up in this industry—and I think I have grown up a lot in this industry—the idea of inside information is emblazoned in you right from the start. I think one of the issues that Mr. Shoemaker raised is that maybe because the market has been going up for years and years now, that there is a whole new group of people that haven't been brought up with those ideas. Inside information is at the top of the list that everybody is concerned about. And it is defined, I think, broadly as material, nonpublic information that is acted upon.

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[1] Information not received at time of publication.

The problem comes in defining what is material and what is nonpublic. So for us in the industry, I would think that anybody acting with first-hand knowledge that a tender offer is about to happen and has not been made public, is acting with insider information.

Senator ARMSTRONG. Well, I don't want to pursue this further than you all want to, but it looks to me like your industry is in a spot where the definition is a lot more subjective than I would wish it to be if I was in your shoes.

DEFINITION IS OBSCURE

You have got people in your industry being hauled off to jail and encountering large fines, and you say it is all very clear, and yet it isn't at all clear to me. I said at the outset that I don't know anything about securities law. What I know about securities law is exactly what any businessman would know. I have never had any prior legislative experience with it, but what you have just told me, Mr. Marron, doesn't add up to me. Now I will grant that that is my inexperience, but it appears to me when new information occurs or becomes available, someone will be the first to know, and my question is, how many people have to know before the first one to know is permitted to act on it?

Mr. MARRON. I think that is an issue, Senator, but I think Senator D'Amato's proposal to better define insider information is a very important proposal. Life is more complicated than it was when these rules were first established. And it is very difficult to know when that line is crossed, and it is the subject, many times of hours of debate as to whether it has been crossed or not.

Senator ARMSTRONG. Well, let's take a very real situation where security analysts go to visit a company and have a discussion with officers of the company, and they spend all day asking them every question in the world about it. And then they go back to their shop, and they say, "You know, there is a company that is really going some place. Let's put it on our buy list."

Now there may not be quickly available, or at any other time, any general publicity about that. The only people who will know that are people who are at that meeting, which might be 6 people, might be 60, but it wouldn't be a large number, and their firms. Those who they tip off to this information. In fact, I guess most of us in this room have, at sometime, gotten a call from our broker who says, "Boy, I've got news of a company that is really going places." And I say, "How do you know that?" "Well, we've got an analyst that follows this stock. I mean, he lives and breathes this stock all the time. He's just come back from a meeting, and he says, that, by gosh, their earnings next quarter are going to be higher."

Mr. MARRON. That's what his job is. That's why he is called an analyst to try and analyze information and make projections.

Senator ARMSTRONG. Exactly, but what isn't clear to me is, when does this become insider information?

Mr. MARRON. It's not clear to us either. That is why we, in Paine Webber, have a prohibition against acting in inside information, and we train our people that, as information approaches the gray

area, that they must go to their supervisor and turn to legal counsel, if they are not sure.

Senator ARMSTRONG. In that case, you would permit analysts, I take it, to go to such a meeting?

Mr. MARRON. Oh, certainly, yes. That's their job.

Senator ARMSTRONG. And to formulate a recommendation, based on that.

Mr. MARRON. Yes.

Senator ARMSTRONG. So you don't think, in that case, that is insider information?

Mr. MARRON. Unless something happened in the meeting, and the management said something that they shouldn't have said.

Senator ARMSTRONG. Now you lost me. You mean if there is something newsworthy that happens there, then it is insider information, but if it is just the same old boring stuff, it isn't?

Mr. MARRON. Supposing it was a meeting of six analysts, and the president said, in 3 hours, I am going to announce blank. That is inside information, I think.

Senator ARMSTRONG. I'm on your side, but let me just point out to you that the companies themselves take widely divergent viewpoints about whether or not such meetings constitute insider information.

Mr. MARRON. Yes.

Senator ARMSTRONG. Most companies, it is my understanding, routinely conduct such meetings. A number of companies, based on the advice of their legal counsel will only do so if the press is present.

I would like, as my time expires—and I do want to come back in a second round, I have a number of other questions I would like to get into, but I would like to ask each of the companies to submit to us, if they wish to, a proposed statutory definition of insider trading, if they wish to make any changes in the present definition.

Mr. MARRON. I might just add, in our testimony, at Paine Webber, we talk about the question of a corporate responsibility, as to what kind of information to provide, and when.

Senator ARMSTRONG. Thanks.

Senator RIEGLE. Senator Armstrong, I might just say before going to our next Senator, that when our next panel comes to the table—I am very much of the view that we need a sharper definition of insider trading, and how that gets crafted and when that gets crafted is a question separate and by itself. But I intend to pose to the next panel, specifically, some suggestions as to how we might go about getting that sharper and clearer definition, so that we have a less ambiguous situation, which is troubling to many Senators, I think, on both sides of the aisle, plus even yourselves, and particularly in terms of the changing nature of the business.

So we will pursue that, and I think that is very important questioning that we have been on here. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Gentlemen, I am very tempted to start off by asking the chairman of The First Boston Corp., how he knows that we are at the tail end of a long bull market? [Laughter.]

If you know that, and you're right, a lot of people can go short and make a fortune.

Mr. MARRON. That is real inside information.

Senator PROXMIRE. That insight, coming from the head of The First Boston Corp., means something.

But I am not going to trade on it. [Laughter.]

ABOLISH ALL CONSTRAINTS

Let us assume that the view of the scholar cited by Senator Armstrong, who, I believe may be Professor Mann of the George Mason University, are correct. Let us also assume that we abolish all restrictions and restraints and penalties for insider trading and let her rip. Let Messrs. Boesky and Levine and others do whatever they want. If they make a lot of money, God bless them.

Senator ARMSTRONG. Mr. Chairman, if the Senator would yield for a moment, I just want to make it clear. I was not advocating that.

Senator PROXMIRE. I know you weren't.

Senator ARMSTRONG. But I do advocate that it is a point of view we ought to at least listen to. I personally think it is far-fetched.

Senator PROXMIRE. I think that is right. But I think the subcommittee may be moving in the direction, at least on the basis of the questioning, that if we can't do everything, we do nothing. And I think there are things we can do.

It seems to me that what we are really, really concerned about now is not inside trading, related to what has been going on for a long time, skipping a dividend, increasing a dividend, a big gain or a big loss that has taken place. That is insider information. It shouldn't be traded on. It is illegal to do so, and it is wrong.

But the big problem now is the merger and acquisition fever that has gripped the country, and when people know that a takeover is underway, just a few people know it. Obviously, they can make a killing. And they do make a killing. Now that, it seems to me, is what we are trying to get at now. We are concerned about these other things too, but the merger and acquisition situation is what we are really trying to reach.

Let me start with Mr. Rittereiser. Mr. Rittereiser, you make an excellent statement on internationalization, and I hail it. It was good. I was surprised too that Chairman Volcker was able to get that agreement on the capital that a bank should have, internationally.

But in your testimony, I missed your suggestions on what specifically the SEC should be doing, which it is not presently doing, to bring about improvements in our securities markets.

Do you agree with those who claim that the present Commission has been too wedded to the premise, that "The market is the best regulator," and such a premise is incompatible with Congress' decision in 1934 to establish an agency to protect market investors?

Mr. RITTEREISER. No. Senator, I go to the point I made about the 1975 act, which I think very strongly reinforced the role of the SEC

and gave them even clearer authority over the self-regulatory organizations, and I believe that they have used that strength extremely well in recent years. I do believe that the markets, generally speaking, do have self-correcting mechanisms, and if the SEC, which I think it has done, carefully follows up on trends that are—or incidents that are questionable, researches them and eventually brings a vigorous follow through in their police role, that they, in fact, serve their function really quite well. I think they have been reasonably aggressive, intelligent and creative in this area. I do think they probably could use more resources to do better analysis sooner and use the——

Senator PROXMIRE. Use the better analyses. Now one of the things they have done is to recommend an increase, I understand a 30-percent increase in their overall budget and a very big increase in the enforcement branch. Is that the kind of thing that you think they should have done earlier?

Mr. RITTEREISER. That is the kind of thing that I think will be an effective follow through on the action they have already taken, but I think generally, they have done a very, very good job and very much in the spirit of what I think was intended in the 1975 act.

Senator PROXMIRE. Now Mr. Marron, you stated about as well as anybody I have heard state it—I am going to criticize what you stated, but you stated it about as well as anybody I ever heard state the bad effects of insider trader abuses.

You said,"They begin to erode this indispensable confidence by causing ordinary investors to believe that ordinary markets are not fair and the values they read in the papers may not reflect the true values of the securities they are holding or want to buy or sell * * *"

I think that is actually right, but it is a general statement. Can you be more specific? Can you give us two or three explicit examples of how insider trading affects the integrity of the market and, therefore, is going to do damage to our ability to raise capital and to advance our economy?

Mr. MARRON. Well, I think that there are several examples, Senator, that you can make. I think, first of all, talking about the individual, particularly the individual that is not operating, perhaps in New York or in a media center, the high volatility in the markets create for the individual a sense of uncertainty, a sense that there are greater forces at work than he can understand. That has the effect, in turn, of either keeping him out of the market or moving him more to an institutionalized product like a mutual fund.

INSTITUTIONALIZED INVESTOR

Now you can argue that is good or bad, but if all the money in the world was institutionalized, it probably would not be good, because the markets benefit from the interaction of all kinds of buyers and sellers.

Senator PROXMIRE. Even if it is institutionalized, we talk of the little investor and the public investor, the institutionalized investor. Wisconsin, for instance, has an enormous, $6 billion pool that they invest. They are a big player, and they are not insiders.

Mr. MARRON. Not at all, no.

Senator PROXMIRE. Most institutional investors are not insiders. They have no tip, and there is an enormous amount at stake here, and it seems to me that they are damaged.

Mr. MARRON. I think they are. There are many examples of clients who shy away from particular companies or investments at a time that there is this extraordinary volatility going on, because of rumors or other activities. There are examples of companies having sold stock too soon or too late, because instead of making a decision, say, in Wisconsin, on the fundamentals, they are trying to outguess the market, in terms of a rumor or a perceived thing that a takeover is coming. I can't give you the specific company and the specific stock, but I would say every week there are examples of that.

And the effect of that, on a long-term basis, would be to tell people, you better stay away from this kind of security or this kind of activity, because there is something going on in there that you don't understand and can't know about. And that is the risk.

Senator PROXMIRE. You have a situation where billions of dollars are traded, and they are sometimes traded, apparently, on the basis of people knowing, for sure, the stock is going up, because you have people who have the capital behind them who are going to go to a certain price, before they cut it off. They know that a few insiders are going to clean up, and it means that it will be at the expense of the people who are playing it straight, no matter how diligent or how smart or how careful they are in trying to analyze the genuine values of the securities that they buy.

Mr. MARRON. That is right. The definition of a securities market ought to be and always has been an informed buyer selling to an informed seller. And therefore, that is a fair price, and if one is more informed than the other, then you have problems.

Senator PROXMIRE. Now a major part of the remedy, I take it, has to be disclosure, the fullest possible disclosure, timely, comprehensive, and then, of course, even under the fullest disclosure imaginable, you are going to have some people who are going to have information, and they must be prohibited from trading, as long as they have it as insiders.

Mr. MARRON. That is right.

Senator PROXMIRE. And that must be enforced.

Mr. MARRON. But the faster that the information gets out, the harder it is to have abuses.

Senator PROXMIRE. What is it, a 13-day or a 14-day, I have forgotten?

Mr. MARRON. A 13-day, yes.

Senator PROXMIRE. The 13-day, all right.

Mr. MARRON. Maybe there is a 14-day too. I only know about the 13.

Senator PROXMIRE. The 13-day requires somebody who is acquired 5 percent of the stock of a corporation to notify the SEC within 10 days.

Mr. MARRON. Right.

Senator PROXMIRE. And the SEC has suggested that it be only 2 days.

Mr. MARRON. Yes.

Senator PROXMIRE. Why can't they be instantaneous? After all, this is the age of computers. People know when they are making that kind of investment. Why can't they immediately notify the SEC? The SEC could immediately make it public.

Mr. MARRON. Well, if they could do that, that would be terrific, and that is what is EDGAR system, I guess, in part, is designed to do. There always is a time thing, unless you can do it on computers directly. But 10 days is clearly too long.

Senator PROXMIRE. Computers can make 2 or 3 billion calculations in 1 second. They certainly ought to be able to give us information immediately.

Mr. MARRON. All you have to do is hook them up, and do that, Senator. That is absolutely right. And 10 days. Nowadays, with the volumes so high, you can do a lot of damage in 10 days. So the faster the better. If you can get down from 2 days, to 1 day or no days——

Senator PROXMIRE. Well, as an expert, do you believe that it is practical to get it down to the same day?

Mr. MARRON. I think, theoretically. Right now I said 2 days, because I don't think that the computer power is in place to do it any quicker.

GREED IS THE CANCER OF THE INDUSTRY

Senator PROXMIRE. Mr. Shoemaker, Felix Rohatyn, of the investment banking firm of Lazard, Freres, testified on January 28 before this committee. He said, there is a cancer threatening the investment banking industry and that cancer is greed. Insider trading, he said, was but one manifestation of the cancer.

Do you agree with Mr. Rohatyn and with Mr. Marron who contends, on page 5 of his prepared statement that the abuse of insider information has grown systemic and must be stopped? If you do agree, what are your recommendations for dealing with that situation?

Mr. SHOEMAKER. I absolutely agree, as I made clear. The intregity of the marketplace is absolutely essential to the long-term well-being of all our honest employees and the shareholders of our company. In order to reduce and eliminate insider trading violations, I think that the No. 1 key element is as early as possible giving information. In other words, the question you just raised to Mr. Marron of whether you get it from 10 days to 2, can you can get it down to zero days, everything that we can do to make sure that information flows out to the light of day, because it is the light of day, it will cleanse and take away most of the opportunity for inside trading.

Any of those kinds of things that we can do, the mechanical basis will all help. Unfortunately, there are still going to be a certain element of people who, if they go out to commit a crime that will find a way to do it, but as a principle, that is the best way that I know to reduce the opportunity for that kind of crime.

Senator PROXMIRE. Mr. Rittereiser.

Mr. RITTEREISER. I would just like to comment that I think that this problem really is in the hands of relatively few people. Everybody in the industry is very, very upset at the people who have

done this. I can just imagine how the people at Kidder Peabody must feel about Mr. Siegel. We have 18,500 employees, and when something goes wrong in the industry, let alone anywhere in our firm, it lands on many, many innocent people. And I think that we have to keep that in mind. As Senator D'Amato indicated, there are so many people in the industry who are absolutely not involved in these things and wouldn't dream of them.

Senator PROXMIRE. I am sure that Kidder Peabody and Goldman Sachs are two excellent firms, they have fine reputations. The people who work for them are among the very best. Men of integrity. Yet both firms made a lot of money out of this kind of activity, and that is what bothers many people.

Mr. RITTEREISER. I understand.

Senator PROXMIRE. They made millions out of it. I understand that two of the people who have been charged made nothing.

I just have one other question for Mr. Mason. Mr. Mason, Harvey Pitt, a lawyer now in private practice who was a former top SEC official is going to testify in just a couple of minutes. He says, on page 17 of the testimony he will deliver later that, and I quote:

> There can be little doubt that the SEC lacks both resources and the remedies that are necessary if the agency is to deter securities law violations in the most efficacious manner. Saddled by budgetary constraints and a 6-year policy of enforced silence about these constraints, the Commission is in danger of falling behind in the effort to police our securities markets.

Now that is a pretty strong statement. Would you agree with Mr. Pitt, and if so, in what areas is the SEC falling behind and in what manner should we beef up the Commission's authority and resources.

Mr. MASON. Well, I think the statement obviously has truth to it. The degree of the SEC's falling behind is probably debatable. There was a quote before that we have averaged six new people a year for a substantial number of years, and obviously, that number is correct. The fact is, though, we have added computers since then, which has had something to affect the number of people. What a individual can do is substantially greater than a person without computers could have done years ago.

COMPUTER SIDE IS CRITICAL

My feeling is, is that as I stated earlier, we must improve the financial ability of the SEC to expand. I think that the computer side is critical, because that is the one that probably extend them the most, and they can do the most with to help surveil. I do feel in the personnel side, it is also necessary. In fact, I do believe that you cannot just through enormous sums of money at any agency or any company, and they can only expand so rapidly, but at minimum, they should be given that which they have requested. I think it is absolutely legitimate.

Senator PROXMIRE. And do you think that is enough?

Mr. MASON. I don't think we know yet. The Commission has not asked for more than that or appears not to have asked for more than that, and literally, I don't know how many people you can take on at one time and do a decent job of supervising them.

Senator PROXMIRE. Well, they didn't ask for more resources during the last 6 years. Now we know they should have.

Mr. MASON. Well—I'll just leave that one. I don't think there is an answer I can come up with on that one. It should have been increased consistently.

Senator PROXMIRE. Mr. Chairman, I just can end up by saying why it is such impressive testimony. All these gentlemen are in this business. They are participants, and they represent excellent firms. They are telling us that they think it is time that we cracked down on them. They think insider trading is very serious. They think that we should do everything we can to disclose as much information as possible and take whatever other action can be effective. Coming from people of this professional capability and with the interest they have in this matter, I think makes it most impressive and helpful.

Senator RIEGLE. Thank you, Senator Proxmire.

Senator Hecht?

Senator HECHT. Thank you, Mr. Chairman. Just to say that I enjoyed their opening remarks and I appreciate their interest in trying to work this out. One personal note. I serve on two committees, and the biggest problem, one is Banking and another is Intelligence, and the biggest problem we have in both is greed. So all my problems are not in this committee. [Laughter.]

Because our Intelligence Committee is also fighting with that every day.

I hope in the future I can call on you gentlemen for comments on any type of legislation that's being proposed.

Senator RIEGLE. Thank you, Senator Hecht.

Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

PARAMETERS FOR EMPLOYEES

I want to get back into the definition of insider trading. I gathered from the panel here that perhaps you don't know or perhaps it hasn't been delineated what is insider trading. One of the panel here, or maybe it was all of you, didn't clearly tell us what you told your employees when they came to work for you, what they could do and what they couldn't do. And it looks to me like this is where it ought to start. If you are going to have employees, they ought to know, within certain parameters, what insider trading is, what the law says it is, up to now, by some definitions that have come through the courts or regulations.

Would you comment on that, the panel? Mr. Marron?

Mr. MARRON. Well, in consulting with counsel to just reaffirm that we don't have a definition, he says that Paine Webber has not a definition, but has a prohibition against insider trading. That gets at your question. We don't have an absolute ironclad definition beyond the obvious extreme examples. That is the point. I think we need help in that area, and Senator D'Amato's legislation would be helpful.

Senator SHELBY. Do you think that people like Mr. Boesky and Mr. Levine and others that have been arrested and charged with breaking various insider trading laws, and so forth, knew what they were doing? They knew that they were dealing in insider trading?

Mr. MASON. Well, I don't like to look in somebody's mind. I don't think there is any question in that. I mean, what they did is a direct violation of any law, securities or anything else. You just can't do what they did.

Senator SHELBY. All right. Do you believe there is at least—I think one of you said 15 definitions of insider trading. Are these definitions prohibitions?

Mr. SHOEMAKER. Well, the problem with the definition, it is very difficult to come up—you know, generally insider information is material, nonpublic information. And then when you trade on that by the buying or selling of securities based on that information, you are engaging in the practice. The problem with it is that, I think Don or somebody else described earlier is, you know, getting into when something is material or whether it is nonpublic, whether two people heard it or six people heard it.

You know, if somebody tells you that an oil company just hit a big oil well, if that is the only oil well that company is drilling, that is pretty material. On the other hand, if it is Exxon, why, so they hit another oil well, it doesn't mean a whole lot. So the problem with coming up with a definition is not as difficult as it is taking the facts as they exist and judging at that point in time whether or not it was material.

Senator SHELBY. Do any of the brokerage houses, any of you on the panel, do you have a continuing educational process in your brokerage firms to the employees for the employees as to what constitutes insider trading and let them know that it is prohibited, that you are going to police it, and you are going to stop it right where it begins?

Mr. Rittereiser?

Mr. RITTEREISER. Sir, I would point out that, to begin with, we do have a series of procedures and rules, regulations and things that are all taught to our brokers again before they go to do their job to begin with.

Senator SHELBY. I know that. Now that is when you are training them. What about continuous education and warning?

Mr. RITTEREISER. Well, I would like to comment in a minute. I want to make a point that this whole question of defining behavior, that is, what people are not permitted to do is a very comprehensive task. It is done. It is incorporated in the training. To comment on a point that Senator Armstrong raised earlier, a research analyst who does his homework and is going to write a report cannot trade on that information prior to issuing the report. There are procedures that we follow to be sure that even his analysis, which is nothing more in the end than his analysis, is not acted on until it has been disclosed and disseminated within the company. So we have these procedures——

Senator ARMSTRONG. If the Senator would yield, let me point out that somebody acts on that information first. Somebody does. It's got to be.

Mr. RITTEREISER. Well, somebody does, perhaps, but if it is done properly——

Senator ARMSTRONG. Somebody gets the first telephone call. If he comes back and puts that report on your computer system—forgive me, if I may just take 10 more seconds. He puts that on the com-

puter system. It flashes out to your brokers around the world, and the next morning at 9:00 o'clock, every one of your brokers knows that information. They call somebody first.

Mr. RITTEREISER. But that's what we do for a living. We work hard to do analysis and then disseminate the analysis and the advice.

Senator ARMSTRONG. I am not complaining of it, but my——

Senator SHELBY. I am going to claim my time back, if I can from the Senator from Colorado.

Senator ARMSTRONG. Thanks, Senator.

Senator SHELBY. That's what you do for a living, but you're also charged with not violating the law.

Mr. RITTEREISER. Well, that's correct, and we don't.

Senator SHELBY. And shouldn't that be one of the paramount things that you do in your brokerage firm?

Mr. RITTEREISER. That is exactly the point I am making. We follow procedures to be sure that we do comply with the law. We do train our people in what is permitted and not permitted, and we do have procedures for analysing any activity that goes beyond those bounds, and we do have ongoing educational programs.

Senator SHELBY. Mr. Mason?

Mr. MASON. Senator, just to clarify the issue to make sure we're all on the same thing. Insider information is consistently told to every member of any organization, and I am sure, in all firms, is, any time you have information that is not publicly known or disclosed, you may not use it under any condition. That applies to analysts, that applies to brokers, that applies to everybody.

If a securities analyst, as part of his or her job, goes out and visits a company, which is part of their job, and does the analysis and determines that the company is doing well, the products are selling well, whatever it may be, and comes back and reports that, that is their function. The only time the analyst is in jeopardy on that is if for some reason there is a disclosure made in that meeting that they were not supposed to know, and then the analyst must make a judgment call.

I think that works 99 percent of the time. There is always a time when somebody might get wrong input or the wrong information, but people understand that if they have something that is not publicly disclosed, they may not use it.

Senator SHELBY. Would they better understand—I would like to know your response to this. The U.S. Attorney Giuliani's statement that it would take prison terms of 4 to 9 years to stop or slow down insider trading, wouldn't that be the thing to warn everybody, would be the real educational process there?

Mr. MASON. He could well be right. I honestly do not believe—I mean, the comment that was made before, that those of us that have grown up in the industry and have been through bad markets over the years, have no trouble understanding whether it is insider or not, and I think we're—I mean, I am absolutely amazed at what's going on.

Senator SHELBY. I have a lot of respect for the industry, and it is so important to our economy, but I believe that the integrity of the markets are so important, not only to——

Mr. MASON. I couldn't agree with you more.

Senator SHELBY [continuing]. Not only to this country but foreign nations and individuals that are investing here. So I have trouble with some of the other deregulation. Let the insiders be legal, and so forth, that has been talked about here a little bit.

Mr. SWIMMER. I have no problem with that.

Senator SHELBY. It might take a tremendous criminal investigation and trial to clean some of it up.

Mr. SWIMMER. It would amaze me if what has happened won't clean it up quick. I mean, I just cannot believe that everybody in this industry isn't just stunned by what is going on.

Senator SHELBY. But you all agree that it has to be cleaned up and the integrity of the market has got to be restored.

Mr. MASON. Without question.

Senator SHELBY. Thank you. Mr. Chairman——

Mr. SHOEMAKER. Could I add one comment on it, and that is that I think we are maybe not getting through as well as we could, the fact that we have extremely elaborate internal procedures to—not only do we train and educate the people as they go along, but in terms of continuing surveillance, in terms of making everybody's accounts, for their own account, within our firm or in some other places they may be, that they must send a copy of all transactions to the compliance department, and they are routinely reviewed to see what everybody is trading in and matching it up against where we have insider information.

Senator SHELBY. Mr. Shoemaker, but when at the highest levels or some of the highest levels and some of the most prestigious firms on Wall Street, when there is a conspiracy at the highest level, how is the information of who is trading inside going to come down to the right people, when it is at the highest levels?

Mr. SHOEMAKER. If the appropriate procedures are in place, the legal department is an absolutely stand-alone entity, they are capable of detecting administrative problems, but——

Senator SHELBY. But they weren't in these cases, were they, Mr. Shoemaker? Didn't this come from revelations, and then the U.S. Attorney's Office and SEC working together has done this, rather than internal controls?

Mr. SHOEMAKER. That is correct, because these were not of the routine type nature. These were people——

Senator SHELBY. So this begs the question that you are going to have to do a tremendous job or start all over on internal surveillance to self-regulate your brokerage firm in any way. Is that fair?

Mr. SHOEMAKER. I will go back to the statement that I made originally, which said that there is a role for self-regulation. We can do a lot ourselves, but there is also a need for increased surveillance from the SEC.

Senator SHELBY. There is also a need for the Justice Department and the SEC.

Mr. SHOEMAKER. I said that.

Senator SHELBY. Thank you. Thank you, Mr. Chairman.

Senator RIEGLE. We are going to try to finish here, in order to get to our next panel, and so I have spoken with Senator D'Amato and Senator Armstrong, and we each have brief observations or a question or two we would like to ask, and perhaps Senator Shelby

does too, and then we will move to the next panel, which is really very important.

I want to say two things. First of all, this subcommittee and the full committee is determined to try to do a careful, rational, balanced job in addressing these issues, in terms of legislative changes and remedies that we may develop, and so we are taking the time to inform ourselves and to examine these things as carefully and as fully as we can, in order to try to produce that kind of result. So that is our intention, and we will stay on the course. A second point I would like to make is, and that is, that when I review the circumstances of what has happened so far with the disclosures that are now the focus of this major insider trading problem with Mr. Boesky, Mr. Levine, and so forth, there is a part that still doesn't add up with respect to what has been said here today, at least to my way of thinking, and that is this.

We found out about this web of activity by a fortunate circumstance. Levine was trading offshore through a dummy account. Somebody tipped off the authorities. The authorities were able to track him down on the basis of that tip. And then by putting the pressure on him, the line of dominos began to fall, and it is still falling. I don't know that we have seen all the dominos fall yet.

I think it has gone beyond what most people in the business, including yourselves today imagined could be possible. You expect a few people perhaps behaving improperly in any industry at any time across-the-board, but the extent, and now the level of participation, in terms of senior management figures, I think has shaken everybody. You, by your own comments today, indicate that you are shaken by it. I am shaken by it. Everybody that I talk to that is serious about these issues is deeply disturbed about it.

And yet in a sense, we discovered this by accident. Had the tip not been forthcoming, I haven't seen anything yet that tells me that we would have uncovered this network, and that otherwise, absent the tip, it might still very well be operating today, the same people doing the same things, making and adding to the illegal profits.

So I ask myself the question, was there something deficient in our surveillance techniques? Is there today? If there was this network, might not there not be another network that is working that maybe we have not seen yet, simply because there hasn't been that fortunate tip, and I ask the question not to try to load the discussion, but because I am trying to understand how it is we have come to this point, and what is really going on out there.

When I hear men of your own senior status reflecting amazement and astonishment that this problem has risen as high in the levels of various firms as it has, that tells me that something hasn't been working properly, apart from just these individuals, that our system, to be able to either prevent it or to find it faster and track it down just really hasn't been adequate to do the job. And I think part of it is expanding SEC enforcement, and so forth. The markets are changing. It is getting harder to—but for this scale of activity to go on, I think, really poses the question, has our system of monitoring and preventing this thing been sufficient. And I don't know how you reach any other conclusion but to say it wasn't sufficient.

It shouldn't have come to this level. So you know, I think we are still left with having to fill in some more of the blanks, in terms of what is needed to prevent this kind of thing from occurring in the future, to make sure that there isn't some other web or network like this out here operating that maybe we haven't uncovered yet.

Mr. Marron, you have made a number of specific suggestions, but I think we need more specific suggestions, and I think the industry is in the best position to really make constructive suggestions as to how we find a way to prevent this kind of thing from happening in a more aggressive way and in a more effective way than we manage to have done so far. And you know, I am very sensitive to the point where you can do it and where that capacity leaves off and where laws and Government and enforcement mechanisms have to pick up, but I think we need to hear some more suggestions along those lines, in light of the scale of the difficulty that has now come to light.

PROMOTE SPECIFIC IDEAS

So you know, I would hope that this discussion today would help promote a thought process that would maybe let you come back to us with some more specific ideas here, so that we can really have a working partnership, so that we preserve the best of our capital market system to put an end to these abuses in a way that really gives us some confidence that we have reached in and we have really grabbed hold of this problem. I am not going to make any further comments to this panel.

Senator D'Amato.

Senator D'AMATO. Well, Mr. Chairman, let me say, I think this has really been a very enlightening hearing and a really tremendous beginning, and I want to compliment, again, our panel for having not been as defensive as you might be expected to be, coming forth and saying, look, we see these problems. There are steps we have to take. There are steps that Congress has to take. The question of the international marketplace. You know, we are not going to correct this situation simply by passing the best of laws that everyone could agree upon.

Potter Stewart said it best when talking about pornography. He said, I couldn't define it. I think we have the same problem here. He said, but I know it when I see it. [Laughter.]

Insider trading, you can't define all of it, but certainly, there are those areas that no one will disagree, they certainly know it when they see it.

The gentlemen here have indicated maybe we need something in the way of some definitions that lead to better industry scrutiny as well. They are going to have to step in and take the lion's share, as it relates to the conduct of people who work for them. We are going to have to help and assist with respect to setting clear guidelines that no one can mistake and can't step over. Those who seek to cut corners where there are great sums of money to be made, will look for any avenue to do it. The vast majority of people, you have to promulgate rules and regulations to keep honest people honest. That is what we want to do. You are not going to keep the Boeskies from getting involved in this kind of thing, no matter what laws or

no matter what penalties, but we want to deal with the vast majority of people, let them know that if you cross the line, there are severe repercussions, and that will have a tendency, I think, to assure integrity in the marketplace.

So this is a terrific beginning. I look forward to the input from these gentlemen and from the industry as a whole, so we can deal with this problem in a series, considerate manner and improve the integrity of the marketplace.

Senator RIEGLE. Senator Shelby.

Senator SHELBY. I will be brief. I just want to sum up some of the—thank the panel for your candor here today and the candor in some of the questions that I asked.

I am concerned, as you are, because you are at the top of your professions in the market, and you have a lot of responsibility there, but I believe that here in the Senate, in the Congress, that we have an obligation to the American people that there is integrity in the market, and I know we can't do it just by passing the laws, but some strong laws, some strong enforcement and some internal surveillance by your firms could really stop a lot of this, and I think you are going to have to get into the education and policing of your own people internally. That is obvious from how high it reached in a lot of the brokerage houses.

I look forward to working with you and the chairman and other members of the committee. I think this has been a good hearing and really good beginning, Mr. Chairman,

Senator RIEGLE. Thank you. Senator Armstrong.

Senator ARMSTRONG. Mr. Chairman, I will also be brief, although I do have two or three matters I would like to explore quickly.

One, I just want to note in passing that Potter Stewart may know obscenity when he sees it, but it is pretty clear to me that Mr. Marron and Mr. Mason are not in agreement about whether or not insider trading has gray areas. Mr. Marron used exactly that term to describe it, and Mr. Mason said that in his experience, it was not a great practical problem.

My own view, and let me just say, for the benefit of our panelists, I think, in general, with the exception of Mr. Marron, I have not heard the expressions of concern about the vagueness that I would have expected. I think if I were you guys, I would be terrified by the notion of escalating penalties for ill-defined crimes. The difference between a rule of law and a rule of men is exactly the question of selective enforcement which we already have. We already have a case where selective enforcement permits regulators to really come down hard in very informal and occasionally, at least, improper ways.

So I hope you will send us your thoughts about how to define insider trading, who are insiders, what is material, and some other issues.

ONE VOTE PER SHARE ISSUE

I would like to direct a couple of questions to Mr. Rittereiser. I particularly want to ask a question about the one vote per share issue. You made the observation that--you asked this question. Will reduction of the voting power held by investors, give the board

the power to perpetuate itself without effective change? I think the answer to that question is no.

But just for the record, that is the intention of such voting arrangements; is it not?

Mr. RITTEREISER. Not solely to do that. I don't think it is solely to do that. I think it has, in some cases, other considerations, including very often the attraction of new capital, because of a new class of stock.

Senator ARMSTRONG. Am I mistaken that, in general, that is a device that has been resorted to in the last 3 or 4 years, increasingly by companies for the express purpose of preventing the management from being replaced?

Mr. RITTEREISER. I think it has been used in that regard and has gotten a great deal of focus in that regard, but I think the area where it has also been used to a great extent is in emerging industries in small companies that have a very important need for capital, a very important part of their life, and any rules that would change could very seriously affect a lot of small industries in this country.

So I do think, before any action were to be taken along those lines, the economic issues at stake ought to be focused on and not just the current brouhaha regarding whether or not it meets the listing standards of the New York Stock Exchange or the NASD.

Senator ARMSTRONG. I wasn't really thinking so much about that. I have an opinion about that. I was just trying to be sure whether or not my impression was correct that exactly what companies are doing is entering into voting arrangements which prevent anybody from changing management without the approval of management.

Mr. RITTEREISER. Yes. I think that is part of the reason why the problem is being focused on, because that is, in fact, one of the things that has been getting use for in recent years. No question.

Senator ARMSTRONG. How do you feel about that?

Mr. RITTEREISER. Well, again, I think, in the end, the market mechanisms, as well as the regulatory systems and our own judiciary system eventually take care of it, because if the directors act in an improper manner, it is reflected in the price of the stock. It is reflected in stockholder suits.

Senator ARMSTRONG. I have one more—I've got 50 more questions, but I have agreed to ask only one more.

Earlier—well, I guess, last week, a person in your line of business who occupies a position similar to yours in a smaller firm, approached me privately and told me that he thought he was subject to a vendetta by the Securities and Exchange Commission, and in fact, outlined a series of things that occurred to him, which he said indicated that the enforcement was selective, unfair, unreasonable, and in fact, constituted a personal vendetta, was the term both he and his legal counsel used.

I guess I am not going to ask you to comment on that today, although I would be happy to have anybody do so that wishes to, but my desire is not to put you on the spot, but my desire is to have you call me sometime, if you have information on such matters.

I have had occasion recently to look extensively into the practices of the Justice Department and the IRS, and based upon that

kind of investigation of those two agencies, I was not too surprised by what I was told about the SEC. The more I heard of what we have been discussing this morning, the notion that you have laws with heavy penalties and big economic consequences, which are sufficiently vague that at least some people are in doubt as to what they mean, and then you get zealous prosecutors or zealous regulators running around, it did not take me entirely by surprise when somebody came in and said this was the fact.

So unless someone wishes to make a public declaration on this subject, let me just say that my number is in the book, and I would be glad to hear from you privately, and at least to the extent I would properly do so, I will keep your confidence, if you want to tell me anything, or anybody in the audience.

Senator RIEGLE. Thank you, Senator Armstrong.

Before having this panel disband, let me thank you again for coming. We are interested profoundly in fairness to shareholders and the vitality of the capital markets, and we intend to see that both are maintained in whatever way we can.

I would like to ask, particularly, Mr. Mason, Mr. Rittereiser, and Mr. Shoemaker—Mr. Marron made a number of specific suggestions and recommendations. I would like you to take a look at those. I would like your comments for the record as to whether or not you support or oppose those, or if you have others you would like to suggest, because we want to pin down as well as we can, a road map as to what we ought to do.

So I would appreciate that elaboration in the record from the three of you, if you would.[4]

Senator RIEGLE. Thank you very much. We appreciate your participation.

Let me call the next panel to the table, and a distinguished panel it is.

We have first, Mr. Milton Cohen, who is a partner in Schiff, Hardin & Waite, who, among other things headed a very widely acclaimed 1963 special study of the securities markets and is an expert in the field. Mr. Harvey Pitt is a former general counsel of the SEC, is a partner in Fried, Frank, Harris, Shriver & Jacobson. And Mr. James Treadway, who is a former SEC Commissioner, who is now a partner in Baker & Botts.

I think the three of you probably represent as much know-how as we could have on these issues from an arm's length point of view from trying to put three peopie at the table.

So we are delighted to have you, and we have your statements.

Mr. Cohen, I am going to have you begin and summarize your remarks, if you would, and any references that you want to make to other things we have heard today, as you go along, please do so.

STATEMENT OF MILTON H. COHEN, PARTNER, SCHIFF, HARDIN & WAITE

Mr. COHEN. Mr. Chairman, Senators. I was an SEC staff member very early in its history, from 1935 through 1946. I came back in 1961-1963 to head the special study of securities markets.

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[4] Information may be found on pp. 142, 157, 172, 188, and 191.

Between my two stints, and again from 1963 to date, I have been in private law practice.

I have submitted a rather long written statement, in which I discuss the broad topics that were listed for today's hearings. Today I shall briefly discuss some aspects of the Commission's administration of the Securities Exchange Act of 1934 in its early history, and also in the 1960's, including the work of the special study. I believe that a review of these earlier periods is not only the most effective way to present my appraisal of the present state of affairs but also may highlight some worthwhile 'essons from the past.

ATTITUDE OF HIGH RESPECT AND ADMIRATION

I want to emphasize that when I contrast the present Commission with its predecessors, the contrast is only a matter of degree. Although I am critical about some things, my basic attitude toward the Commission continues to be one of high respect and admiration.

In 1961 Congress and the Commission were concerned that the statutory and regulatary provisions adopted in 1934 and in the Comission's early years might not be well adapted to deal with later developments. Accordingly, Congress authorized the hiring of a special staff to conduct a study of the adequacy of the regulatory pattern.

The professionals consisted mostly of lawyers, but also included excellent economists. Many statistical data were compiled, but statistical data and analyses were only the beginning. Most of our work consisted of gathering and analyzing nonquantitative information, studying historical origins and causes of new phenomena, identifying their apparent or likely consequences and implications, and, where appropriate, recommending remedial measures.

Among many topics that we studied in depth were the fixed commission rate structure of the stock exchanges, the increasing institutionalization of the markets, rapidly advancing automation capabilities, and the functioning of the self-regulatory system and SEC oversight thereof.

Our work prompted many important improvements and changes in the regulatory pattern, making it basically suitable, I think, for the market circumstances after 1963 and until recently.

But apart from our specific recommendations, the special study emphasized the dynamic character of the markets and expressly recommended that the Commission should establish a separate, permanent policy and planning unit within its staff, having the responsibility of accumulating and analyzing pertinent data bearing on market patterns and practices generally, making special studies as the need may be indicated, and reviewing policies and regulations in light of changing circumstances.

Nevertheless, since 1963, and especially in the last several years, there have been many new developments and potential new problem areas that appear to me to be as important and as much in need of systematic, broad and deep analytic studies, such as those covered in the special study, but that are not receiving such study.

Among others, these include not only the problems of insider trading, but bidders' and target companies' conduct in takeover

contests, operations of risk arbitrageurs and investment bankers in connection with takeover contests, unprecedented aggregations of capital for investment or trading, a vast increase in proprietary trading by broker-dealer firms, new uses of automation, including program trading, new interrelationships among securities markets and new combinations of equities and futures trading, increased use of junk bonds, internationalization prospects, and new questions of Federal versus State regulation of certain aspects of corporate governance.

That the recent developments are not receiving the kinds of studies that pre-1963 developments received is basically explained, I believe, by the facts that, first, the present Commission takes a much less activist view of its regulatory role and is much more deregulation inclined than most of its predecessors; and second, whether as cause or effect, so-called Chicago economists and economic thinking now exert greater influence than before. One manifestation of the later point is that the policy and planning unit that we recommended in 1963 is now known as the Directorate of Economic and Policy Analysis and appears to be staffed entirely by economists of the so-called Chicago school.

Further, the Commission's economists seem to rely primarily on econometric approaches, based on quantitative data rather than on broader analytical approaches, using nonquantifiable data.

When I refer to the Commission as "deregulation inclined," I use "deregulation" to mean not only rescissions or relaxations of existing measures, but also a disinclination to take new regulatory initiatives, including recommendations of new legislation, even where measures designed for earlier market circumstances may have become irrelevant or ineffective in relation to new circumstances.

While it is not easy to sort out causes and consequences of the deregulatory trend, in my prepared statement I identify three main factors.

MARKET IS THE BEST REGULATOR

First, the present Commission tends to follow the economists' watchword that "the market is the best regulator." Where the subject matter is the securities markets themselves, the notion of the market regulating the market appears to me to be in conflict with the basic premises of the Federal securities laws: that securities are inherently "intricate merchandise"—that phrase was used back in 1933 by Congress—that the peculiar complexities of the securities markets are beyond the experience of most public investors; and that a special statute and a special regulatory agency are needed to provide protection for investors and the public interest.

Second, there is now a tendency to emphasize competition as such, without adequate concern, it seems to me, about the level at which the competition occurs and without sufficient attention to the fact that Congress, even while giving renewed emphasis to competition in 1975, made clear that it meant "fair" competition and insisted repeatedly that the regulatory purposes of the act should always be paramount.

Third, the Commission's actions and inactions sometimes seem to reflect a belief that an affirmative regulatory solution is not

needed unless and until there are historical, quantitative data that show actually experienced "statistically significant" harm. As a corollary, I believe the Commission has sometimes given insufficient weight to broad public policy concerns, even some expressly reflected in the statute, if they are not susceptible of statistical measurement.

My prepared statement sets forth my reasons for believing that at least some of the recent developments that I enumerated before are in need of broad analytic study, somewhat in the manner of the 1963 special study. In some instances, I give my impressions about specific types of reforms that might be the outcome of the studies; however, my purpose generally is not to urge particular regulatory action on any subject, but simply to urge that new or emerging problems of apparent seriousness should be subjects of early and adequate studies to determine whether any regulatory measures might be needed.

I very much welcome the fact that the Senate, through this committee, is pursuing many of these questions that I think are in need of serious pursuit. In my paper I talk about the need for SEC study of some of these things, but I think the fact that the Senate is moving into these areas is most welcome.

In the time remaining, if I have some, I will summarize my thoughts on one or two subjects, and I will be glad to answer questions about these or other subjects later.

First, regarding insider trading. The Commission's agenda is apparently oriented toward detection and enforcement rather than toward exploration of the reasons why insider trading abuses have become such a major scandal, particularly in connection with takeover contests.

Current takeover regulation still places an unacceptable premium on the elements of speed and surprise. Taking one's adversary by surprise, in order to cut down his reaction time, is the antithesis of making prompt and full disclosure. Thus, takeover contests, although they are not the only source of inside information problems, themselves are veritable breeding grounds for nonpublic but material information.

I believe the Commission must reexamine what disclosures must be made and when, in the course of takeover contests, so as to cut down the very supply of inside information that stems from the present system of delayed and incomplete disclosures.

SEC ACTIONS ON TAKEOVERS

Regarding takeover contests, including activities of risk arbitrageurs and investment bankers, the Commission's actions and inactions appear to me to have been heavily influenced by the economists' concept of a "market in corporate control," as an important source of management discipline.

While this concept may be a useful one, I believe it has been given excessive weight in several respects. First, whereas the Commission shows considerable concern about the respective roles of management and stockholders on the target side, little concern is shown about the same subject on the bidder's side. In particular, little concern is shown that burdensome financial commitments

and other massive and possibly deleterious changes can often be undertaken by bidders' managements without acquiescence by stockholders.

Second, while the Commission has been generally tolerant of innovative, aggressive tactics on the bidder's side, it has not supported or has actually opposed various novel defensive tactics.

Third, the several studies of tactics of bidders or targets that have been published or cited by the Commission are mostly confined to statistical measurements of short-term market price impacts on the target side, without sufficient attention, it seems to me, to longer term price impacts on all sides, let alone broader, more important, but not easily measurable concerns about impacts on the securities markets' functioning as price discovery mechanisms, on the ultimate fate of particular businesses, or on the national economy and national welfare.

Fourth, the economists' market in corporate control is referred to and relied upon as if it were simply an arena in which present managers and would-be managers contend for the right to control, without sufficient recognition that the dynamics of takeover contests are often greatly affected, if not governed, by the activities of ancillary participants such as risk arbitrageurs and investment bankers. Not only are these ancillary participants often in a position to dominate the step-by-step progress of a takeover contest, they stand to gain immensely, or in the case of the arbitrageurs, gain or lose immensely, depending on the outcome.

In this sense, the market for corporate control is both more and less than a source of discipline for corporate managers. And the Commission's reliance on such a market as a major premise of its policies concerning takeover contests seems excessive.

Senator RIEGLE. If I may, at this point, only in the interests of the time that we have in hearing our other witnesses, if I can, I am going to ask you to try to finish in another minute or minute and a half, can you do that?

Mr. COHEN. Yes, sir. I will turn to one subject that I don't think has been mentioned by anybody else that I would like to address at this point. I can later talk about the subcommittee's questions concerning the Commission's resources and the division of regulatory responsibility, which are covered in my written statement.

In addressing the problem of regulation of takeover contests and other problems that straddle the line between the securities regulation area and the corporate governance area, one is soon confronted with issues of Federal versus State jurisdiction. For many years, securities regulation has been dominated by Federal law, whereas corporate governance has been thought of as basically State law concern. Nevertheless, the corporate governance field has in fact been extensively, but unevenly, taken over by provisions of the 1934 Act, as amended by the Williams Act and other acts.

The result is a patchwork of Federal statutory law, State statutory law and a no man's land of jurisdictional uncertainty.

The intertwined nature of what might formerly have seemed to be separable Federal and state law concerns has become increasingly clear, particularly in relation to takeover contests. I suggest the time has come for serious consideration of possible amend-

ments to the 1934 act, to deal in a unified way with all aspects of takeover contests and similar matters of national scope and import.

Thank you.

[The complete prepared statement of Milton H. Cohen follows:]

STATEMENT

of

MILTON H. COHEN

before the

SECURITIES SUBCOMMITTEE OF THE COMMITTEE

ON BANKING, HOUSING, AND URBAN AFFAIRS OF THE

UNITED STATES SENATE

February 24, 1987

I was an SEC staff member very early in its history, from 1935 through 1946. I came back in 1961-63 to head the Special Study of Securities Markets. Between my two stints at the Commission, and again from 1963 to date, I have been in private law practice with the Chicago and Washington firm of Schiff Hardin & Waite.

My firm, and I personally, have represented in various ways the Midwest Stock Exchange, Chicago Board Options Exchange, New York Stock Exchange, Options Clearing Corporation and a number of broker-dealer firms and others having business at the SEC. However, my remarks today are entirely personal and do not necessarily represent the views of my firm or of any client.

The breadth of the topics to be discussed today compels one to generalize and therefore oversimplify. Many of my remarks are doubtless subject to significant exceptions or qualifications. Further, where I contrast the present Commission[1/] with predecessor Commissions, it should be understood that the contrast is generally only a matter of degree. Although I may be critical or quizzical about many parts of the Commission's record, I would also commend many other parts, and my basic attitude toward the Commission as an institution continues to be one of high respect and admiration.

My remarks relate primarily to the Commission's administration of the Securities Exchange Act of 1934 (1934 Act). Essentially I will be comparing the present Commission's approach to issues of today arising under the 1934 Act, insofar as I am able to observe it from the outside, with earlier Commissions' approaches to more or less comparable issues facing them during my two periods as a staff member. I believe this comparative treatment will not only be the most effective way of presenting my appraisal of the present state of affairs but may also serve to highlight some lessons from the past that might well be given greater heed today.

I. Earlier Activist Commissions -- The 1963 Special Study.

The enactment of the 1934 Act and the creation of the SEC had been preceded, of course, by the Great Market Crash and by revelations, through intensive Congressional investigations, of various kinds of outrageous or at least highly unacceptable behavior in the securities markets. The 1934 Act dealt with some problems directly and also gave the SEC broad authority and responsibility to protect the interests of investors and the public interest through specific regulations.

The earliest years of the Commission were marked by very lively activity, but not without restraint. For

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1/ In referring to the "present Commission" throughout this Statement, I mean basically the Commission as constituted since Chairman John S.R. Shad succeeded Chairman Harold M. Williams, but I of course recognize that the membership of the Commission has undergone changes in this period and also that there are and always have been differences in general or specific viewpoints and occasionally in formal votes among the five Commissioners.

example, after intensive study of the question of segregating the dual functions of broker-dealers, the Commission decided to impose certain regulations on their conduct without compelling segregation.

The new law and new Commission basically accomplished the reforms that were originally expected of them. Among very many examples of the Commission's positive use of its regulatory powers in the early decades to foster fair and orderly markets, I will mention only that the Commission adopted the broad, basic anti-fraud rule (Rule 10b-5) that underlies the present-day ban against insider trading as well as numerous specific restrictions on manipulative, fraudulent and deceptive acts.

Nevertheless, by the early 1960's, a new scandal had erupted at the American Stock Exchange and there was an ongoing and worrisome "hot new issue" phenomenon. More broadly, when the Special Study was authorized by Congress in 1961, there was a sense, in Congress and elsewhere, that the Commission might have become too complacent or passive in facing up to its statutory responsibilities. It was not that the Commission had become unconcerned about scandalous events or gross violations, but that it might not be sufficiently concerned with, or even aware of, more subtle yet massive changes in the securities markets and their environment that had begun to show up in the quarter century since the basic securities laws were enacted.

As I will further develop below, I believe that the present state of affairs bears considerable similarity to the state of affairs in 1961, even though the specifics are naturally different.

The 1963 Special Study Report[2/] covered a broad range of subjects, made many recommendations, and instigated many important reforms, including greatly strengthening the self-regulatory system under the 1934 Act; extending the 1934 Act's corporate disclosure and proxy requirements to thousands of over-the-counter companies; improving performance and supervision standards relating to broker-dealer selling practices; and strengthening standards and controls

2/ Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95 (Parts 1 through 5), 88th Cong., 1st Sess. (1963).

regarding conduct of stock exchange specialists and floor traders as well as of participants in the over-the-counter market.

But what ultimately may have been more important than any of the immediate reforms, the Special Study made the first organized studies of some relatively new or just-emerging phenomena that seemed in need of regulatory attention, and possibly regulatory action, if the basic goals of the 1934 Act were to continue to be realized in the current and future circumstances, and not just 1934 circumstances. For example, we described in depth the anomalous and intolerable consequences of the fixed commission rate system of the exchanges and the quotation systems of the over-the-counter market; we made the first significant public study of the relatively new but fast-growing phenomenon of institutionalization of the markets; we took the first serious look at interrelationships -- operational and competitive -- among markets; and we made a first start at studying the potentials of automation in the securities markets, not only in creating new efficiencies in the operation and the surveillance of the markets themselves but also in presenting new opportunities for market participants and new challenges for market regulators.

We emphasized that the vast changes between 1934 and 1963 were not the end of the road: the market scene would continue to be kaleidoscopic, not static. Therefore, in addition to many recommendations with regard to specific topics, we made these more general recommendations:

> It is essential for the Commission to improve its facilities and programs for continuous accumulation of data with respect to fundamental, but often obscure, changes in the components, uses and needs of the total pattern of trading markets....
>
> The Commission should establish a separate, permanent policy and planning unit within its staff, having the responsibility of accumulating and analyzing pertinent data bearing on market patterns and practices generally, making special studies as

the need may be indicated, and reviewing policies and regulations in light of changing circumstances.[3]

II. The Present Deregulatory Trend -- The Influence of "Chicago" Economists.

The Special Study marshalled a great volume and variety of data, qualitative and anecdotal as well as quantitative. We had economists' contributions of very high quality, but perhaps not enough in quantity relative to the input of lawyers. But, on the latter score, it appears to me that the pendulum has now swung too far the other way. "Chicago" economists and economic thinking now carry far too much weight in my opinion. One significant manifestation is that the "policy and planning unit" that we recommended in 1963 is now known as the Directorate of Economic and Policy Analysis and appears to be staffed entirely by economists of the "Chicago" school, as is the Commission's separate Office of Chief Economist. Further, both sets of economists primarily rely on econometric approaches based on quantitative data, rather than on broader analytic approaches using non-quantifiable data, and both appear to operate largely independently of the Commission's administrative and enforcement staffs.

Of course, the present conspicuousness of the Chicago school of economists both reflects and contributes to the circumstance that the 1980's, unlike the 1930's and the 1960's, are, politically, an era of deregulation. Deregulation being an avowed goal of the present Administration, it is only natural that this would be reflected to some degree in the Commission's personnel, budget, and programs. A trend in this direction was probably not only inevitable but desirable, especially with regard to essentially economic matters such as prices, at least where competitive forces can be relied upon.

With regard to questions of business conduct, however, I personally believe that the present Commission leans too far in the direction of deregulation. I include in the term "deregulation" not merely actual rescissions or relaxations of existing regulatory measures, although there are many examples of such, but also avoidance of new regulatory

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[3] Id., Part 5 at 148.

initiatives that might be undertaken by a more activist Commission in light of new market circumstances. After all, in a highly dynamic field where old concerns are constantly being replaced by new ones or taking new forms, avoidance of new regulatory initiatives is the practical equivalent of deregulation. Also, I use the term "regulatory initiatives" to include not only actions that might be taken by the Commission itself under existing law but also, where appropriate, recommendations that might be made by the Commission to the Congress as to needed changes in the law.

It is not easy to sort out causes and consequences of the present deregulatory trend, but I see the following interrelated factors at work:

First, the present Commission tends, more than its predecessors, to follow the watchword of the Chicago economists' school: "The market is the best regulator." That watchword may be appropriate for many subject matters, but where the subject matter is the securities markets themselves, to say "Let the market decide whether and how the markets should be regulated" strikes me as either a tautology or a contradiction. At any rate, the thesis, if carried too far, appears to me to be in conflict with the basic premises of all the federal securities laws: that securities are inherently "intricate merchandise";[4] that the peculiar complexities of the securities markets are beyond the experience or understanding of most public investors (and perhaps even many institutional investors); and that a special regulatory agency is needed to provide protection of investors and the public interest.

Second, while the Commission has always been concerned about the appropriate balance between competition and regulation, a particular concern in times past was that various types of competition might cause a "race to the bottom." Further, while the 1934 Act as amended in 1975 places much emphasis on competition, the statute repeatedly makes clear that Congress had in mind "fair" competition and intended that the regulatory purposes of the Act would always be paramount over competitive aims (e.g., Section 23(a)(2): "[Rules of the Commission] shall not...impose a burden on competition not necessary or appropriate in furtherance of the provisions

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[4] H.R. Rep. No. 85, 73rd Cong., 1st Sess. 8 (1933).

of [the 1934 Act]"). With the present emphasis on competition as the best regulator, I believe there is a tendency to rely on competition excessively, without adequate concern about the level at which competition occurs.

Third, the Commission's reliance on economists of the econometric school has tended to lead to the attitude that a problem does not exist, or at least no regulatory solution is needed, unless and until actually experienced harm is demonstrable and measurable. In practice this often means that there must be historical, quantitative data that can show, through a regression analysis, "statistically significant" harm. (Query whether the ban on insider trading, enforcement of which is currently one of the highest priorities on the Commission's agenda, would ever had been adopted if such an approach had always prevailed.) As a corollary, there is a tendency to give too little consideration to public policy concepts, including express statutory ones, that involve other than statistical data. In other words, marshalling and analyzing of qualitative or judgmental data tend to be downplayed relative to reliance on regression analyses of quantitative data.

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I would now like to comment on how the factors I have just enumerated appear to affect the Commission's performance in a few currently conspicuous areas of the Commission's work.

Insider Trading.

In this area one cannot say that the influence of Chicago school economists is strong, or even present. The most extreme of the economists would say that insider trading is an aspect of a free market and is more beneficial than harmful, whereas it is obvious that concern about insider trading -- which in its modern form originated with the activist Commission of the 1960's -- is among the highest of the present Commission's priorities. Within the limits of its resources and its conceptions, the Commission appears to be doing an effective job. However, rather typically, the Commission's concern appears to be oriented almost entirely toward detection and enforcement, rather than toward exploration of the reasons why insider trading abuses have become the major scandal of the 1980's.

Why has insider trading reached such scandalous proportions within the past few years, and why particularly so in respect of takeover contests? Apart from new heights in greed and new depths in business morals, which seem to have become all too prevalent, I believe the answers lie in the manner in which takeover contests are permitted to be conducted and the degree to which timely disclosure of material developments can be avoided. As I will further discuss below, what the Chicago economists describe and defend as the "market in corporate control" too often resembles, in another aspect, a complicated war game in which the major participants and their allies are constantly thinking up and carrying out new offensive and defensive tactics, and hiding them as long as possible, so that an adversary's reaction time and choice of responses will be as limited as possible.

Taking one's adversary by surprise for the purpose of cutting down his reaction time is the antithesis of making prompt and full disclosure. Thus, takeover contests are veritable breeding grounds for non-public but material information. If insider trading abuses in their currently most virulent form -- in connection with takeover contests -- are to be brought under better control, I believe that the Commission must re-examine its rules bearing on what disclosures must be made, and when, concerning developments in takeover contests. For example, in addition to drastically shortening the 10-day period for filing a Schedule 13D after a bidder has accumulated 5% of a target's stock (which the Commission has endorsed), I believe the Commission should consider reducing the 5% triggering amount to (say) 2% and, perhaps most important, should consider how far it can go in obtaining more specific and accurate disclosures of intentions and financial means, instead of vague or ambivalent ones, in the Schedule 13D required of potential bidders and corresponding filings or announcements of other participants. (Possibilities for broader and more far-reaching regulatory initiatives regarding the present ground rules for takeover contests are suggested in the following section.)

Hostile Takeovers and Defenses; Activities of Bidders and Targets; Activities of Arbitrageurs and Investment Bankers.

Of course, takeover contests and the activities of the major protagonists and ancillary participants also present a host of policy problems in their own right, which I believe warrant considerably greater, or at least different, regulatory attention than they had been receiving.

The Commission's total performance in this broad area appears to reflect the interplay of three themes: (1) a general leaning toward deregulation, meaning greater reliance on market forces and less on legal controls, (2) an embracing of the Chicago economists' concept of a "market in corporate control" and (3) an inclination to leave matters of "corporate governance" to the several states and to corporations themselves, with minimum federal participation. To the extent that these themes do not always point in the same direction, it is the "market in corporate control" concept that apparently predominates. This market is seen as a major source of disciplinary pressure on the performance of corporate managers and therefore as constituting a constructive and beneficial feature of the corporate economy that, on the one hand, should have maximum freedom from regulatory interference and, on the other hand, may be relied on as a major premise of regulatory policy in the takeover area.

While the "market in corporate control" may be an important and useful concept, I believe that it has been given excessive weight in at least four distinct respects:

First, whereas the Commission (along with other proponents of the concept) shows considerable concern about the respective roles of management and stockholders on the target side, little concern is shown about the same subject on the bidder side. In particular, little concern is shown about the fact that burdensome financial commitments and other massive and possibly deleterious changes can often be undertaken by corporate bidders' managements without any form of acquiescence by stockholders.

Second, with a few significant exceptions, the Commission has been tolerant of innovative, aggressive tactics on the bidder side as being in furtherance of, or at least consistent with, a flourishing "market in corporate control," whereas at the same time the Commission has not supported, or has actively opposed, various novel defensive tactics as being detrimental to the "market in corporate control."

Third, the several studies concerning tactics of bidders or defenders that have been published and cited by the Commission are studies by economists, mostly based on statistical measurements of short-term market price impacts on the target side, without sufficient attention to longer-term market price impacts, let alone broader, not easily measurable, concerns about impacts on the securities markets' functioning as price discovery mechanisms; impacts on the ultimate fate of particular businesses and industries; or ultimate impacts on the national economy and national welfare. (The latter topic is much too large for discussion here, and possibly too large to be addressed by the SEC alone, but I share the concern expressed by members of Congress and others as to whether the net effect of an overly active "market in corporate control" may not be, short-run and long-run, detrimental to the national economy and welfare.)

Fourth, the "market in corporate control" is referred to and relied upon as if it were simply an arena in which present managers and would-be managers contend for the right to control, without adequate recognition that the dynamics of typical takeover contests may be greatly affected, if not governed, by the activities of ancillary participants such as arbitrageurs and investment bankers. (I will return to this subject below.)

Without attempting to provide an exhaustive catalogue of recent Commission actions or inactions affecting the balance between bidders and targets, I believe the following are fairly illustrative of some of the above points:

(1) The Commission has published studies by its economists purporting to show that poison pills unfavorably impact stock prices but that two-tier, front-end tender offers do not. (The titles of the studies are indicative of their narrow focuses and econometric methodology, e.g., "The Economics of Any-or-All, Partial, and Two-Tier Tender Offers" (1985), "Shark Repellents and Stock Prices: The Effects of Antitakeover Amendments Since 1980" (1985), "The Effects of Poison Pills on the Wealth of Target Shareholders" (1986)).

(2) The Commission has adopted the so-called "all holders" rule[5] to preclude defensive action such as was approved under Delaware law in the Unocal[6] case.

5/ Rule 14d-10, 17 C.F.R. §240.14d-10.

6/ Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

(3) The Commission filed an amicus brief in the Household[7] case to urge that a poison pill defense not be permitted as a matter of state law. (It is noteworthy that the actions mentioned in this and the preceding paragraph were taken despite the Commission's ordinary predilection to leave matters of corporate governance to the several states, with minimum federal involvement.)

(4) In July 1986, after having explored a wider range of takeover issues in other ways, the Commission published a "concept release" dealing with just three issues.[8] The Commission has not yet announced what actions it will take, but the issues posed are themselves revealing.

> (i) The first is whether the Williams Act should apply to acquisitions of a substantial percentage of a target company's stock during or shortly after the formal tender offer. If the Commission concludes affirmatively, this would be another of its relatively rare restrictions of bidders' tactics.
>
> (ii) The second is whether there should be a governmental response to the proliferation of poison pill plans. While posing of the issue indicates that the Commission remains open-minded, its past actions and expressions indicate a strong distaste for this form of defensive action on the target side.
>
> (iii) The third item in the concept release is the most novel and perhaps most significant: whether there should be what is called a self-goverance exemption -- often described as an "opt out" provision -- to the "all holders" rule as well as to other provisions of the tender offer rules. I think it is fair to say that the notion of "opting out" is premised on a favorite thesis of the Chicago economists' school -- that corporations are essentially bundles of contracts with which governmental regulation should interfere minimally. That the Commission is seriously entertaining this notion is an indication of how successful the Chicago school economists have been in providing a philosophical basis for deregulation, at least with respect to the subject matter of the Williams Act.

7/ Moran v. Household Int'l., Inc., 500 A.2d 1346 (Del. 1985).

8/ Exchange Act Release No. 23486, [Current] Fed. Sec. L. Rep. (CCH) ¶84,018 (July 31, 1986;.

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Apart from the two main protagonists, bidders and targets, there are important ancillary players in the "market in corporate control," particularly risk arbitrageurs and investment bankers for competing parties, whose activities often are the main driving and shaping force in takeover contests.[9] Not only are the ancillary participants often in a position to dominate the step-by-step progress of a takeover contest, they stand to gain immensely (or in the case of risk arbitrageurs, gain or lose immensely) depending on the outcome. In this sense, the "market in corporate control" is both more and less than a source of discipline for corporate managers, and the Commission's acceptance of the existence and significance of such a market as a major premise of its policies and actions concerning takeover contests seems excessive.

Risk Arbitrageurs. The term "arbitrageur" has recently taken on a strongly negative connotation because of startling revelations of insider trading involving risk arbitrageurs, but that of course is not a necessary or normal combination. In fact, the role of arbitrageurs

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9/ Still another category of "ancillary participants" consists of corporations or individuals who acquire large blocks of stock with ambivalent motives ranging from capturing control (long-range or with a view to quick turnover) to achieving an immediate profit (through simple "greenmail" or by benefiting from a later premium-priced takeover by a third party). Although this category of participants is quite distinguishable from that of risk arbitrageurs, there are enough similarities in the nature and consequences of their activities that I will not separately discuss them, and my references to risk arbitrageurs may generally be read as including both categories.

(without the "risk" modifier) is old, entirely respectable and useful. There is, however, a relatively recent and enlarged role of risk arbitrageurs in takeover contests that would seem to call for broader and deeper exploration than it has been receiving (even in whatever investigations of specific insider trading cases may be ongoing).

After a company becomes a target, or after a target company has actually been "put in play," a very large involvement of arbitrageurs often assures that the company, even if it escapes the original bidder, can no longer remain unacquired or unrestructured. If the arbitrageurs are satisfied that there are no unsurmountable legal obstacles to a particular takeover and that financing appears available, they may put vast sums of their own capital at risk through purchases of target stock. Thus, once they have decided to invest, large-scale arbitrageurs have their own stake in completion of a deal, quite apart from its merits for the target company and its stockholders or for the original bidder or competing bidders. Further, by acquiring voting rights along with stock ownership, they apparently often are in a position to assure that, insofar as the outcome is dependent on votes or consents of stockholders, a deal will be capable of completion by virtue of their own large holdings and those of other arbitrageurs (or investment bankers or institutions).

Investment banking firms. An investment banking firm, as such, may play various different roles in connection with a takeover, negotiated or contested. It may be the first to suggest that a particular acquisition would be desirable. It may then recommend an appropriate price range, as well as the amount and form of financing, and may encourage the bidder to go forward by stating that it is "highly confident" that adequate financing will be available. It may thereafter underwrite a public offering of securities or arrange other financing and, pending consummation of permanent financing, it may provide a so-called bridge loan, sometimes of enormous size, out of its own resources or credit.

When an investment banking firm represents the target company, it very likely will be called upon to render an opinion -- which, in turn, is very likely to be heavily relied upon by directors as a foundation for exercising their business judgment -- that a particular price would or would not be "adequate from a financial viewpoint"; it may explore and evaluate alternative courses of action; and, perhaps

most important, its advice to the directors may determine whether a target company should affirmatively be "put in play," i.e., whether the financial community and possible suitors for the target company should be given to understand that the company is indeed available for purchase. Such an investment banker, like the investment banker for a bidder, stands to earn large fees, the very largeness of which will usually depend on whether a deal is completed and at how high a price. (For particularly unscrupulous individuals, there is apparently a sort of market in inside information -- paralleling or mocking the "market in corporate control"? -- in which inside information gained through breach of fiduciary obligations can actually be sold for cash.) All in all, while the investment bankers ordinarily are not (like the risk arbitrageurs) subject to the risk of loss of their own capital if a deal fails, they can be in a position to earn enormous profits and fees if a deal occurs (or if non-public information which they have sold proves reliable), so that they too may have a major stake in accomplishing a deal.

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Knowledge of the risk position and voting power of the risk arbitrageurs is of extreme importance to the investment bankers for all parties, just as knowledge of ongoing activities and evaluations on the part of the investment bankers is extremely important in decision-making by risk arbitrageurs. Apparently there is considerable movement of non-public information in all directions, among all the ancillary participants and within and among firms; hence the enormous burgeoning of insider trading abuses that have recently been disclosed or apparently are still being investigated.

In any event, as suggested above, it appears to me that the dynamics of a takeover contest often are affected, if not dominated, by the activities -- and the self-interest -- of ancillary players. Indeed, I think it is a fair question whether, at least in some situations, the tail has not begun to wag the dog: whether profit-making and fee-producing activities of the ancillary participants in takeover contests, instead of being incidental and acceptable means by which presumably worthy ends (improvements in management of public corporations and benefits to stockholders) are accomplished, have not sometimes become the primary goals of the ancillary participants, toward the accomplishment of which the takeover contests themselves are the more-or-less incidental means.

Even if the implications of this sort of question carry the point too far, I suggest that the very potency of the roles of the ancillary participants in takeover contests is enough to indicate that heavy reliance on the concept of a "market in corporate control" may be unrealistic or worse. In any case, the same considerations also indicate to me that some essentially unregulated activities of investment bankers and arbitrageurs in connection with takeovers are in need of policy-oriented studies and evaluations, broader than the case-oriented investigations of the SEC's enforcement staff and going beyond the statistics-based work of its economic staff.

Indeed, I believe that the time has come for a thorough re-examination of the entire set of ground rules governing contests for control, with the general goal of having such contests (like the structure of consensual corporate transactions) decided in a fair and orderly manner on their economic merits, on the basis of relevant data and argument, rather than taking on the characteristics of blitzkriegs, in which tactics of speed and surprise -- with the effect if not the purpose of preventing an orderly and informed process -- are likely to be decisive.

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In addressing this problem (and other problems that straddle the line between the "securities regulation" area and the "corporate governance" area, such as the currently lively issue of "one-share-one-vote") one is immediately confronted with issues of federal versus state jurisdiction.

For many years the securities regulation area has been dominated by federal law, whereas the corporate governance area has traditionally been thought of as basically a state law concern. Nevertheless, the corporate governance field has in fact been quite extensively, but unevenly, taken over or at least entered into by provisions of the 1934 Act: In 1934 the Commission was authorized to regulate corporate disclosures, proxy statements and transactions by insiders of exchange-listed companies (Sections 12, 13, 14 and 16), and in 1964 these same provisions were extended to thousands of over-the-counter companies. In 1968 the Commission was given broad authority over tender offers and corporations' purchases of their own shares (Sections 13(d) and (e), and 14(d), (e) and (f)). In 1977 the Commission was given new authority concerning internal accounting controls (Section 13(b)(2)(B)). In 1975 the authority that had been given to the Commission as early as 1934 to review stock

exchange "listing" rules was broadened and strengthened to include the authority to amend such rules (at least arguably including rules dealing with matters of corporate governance) (Sections 19(b) and (c)); and at the same time the Commission was authorized to define securities "qualified" for inclusion in the national market system, at least arguably permitting the Commission to consider some matters of corporate governance as criteria for such qualification (Section 11A).

The result of this series of amendments is -- in general and also in relation to particular types of corporate transactions -- a patchwork of federal statutory law, state statutory law, and a no-man's land of jurisdictional uncertainty. For example, when there is a succession of aggressive and defensive moves by two or more corporate participants in a takeover contest, some are governed by federal law (and are actually excluded from state jurisdiction by cases such as Mite);[10/] some are regarded by the Commission as matters of state law with which it is reluctant to interfere (except, ironically, by occasionally filing an amicus brief discussing issues involving state law, as in the Household case mentioned above);[11/] and some that probably could and should be explicitly addressed remain in a realm of uncertainty.

The present Commission has not been inclined, as more activist predecessor Commissions might have been, to deal with new important issues of corporate governance by invoking (or seeking to invoke) its authority under Section 19 to amend "listing" rules or its authority under Section 11A to define "qualified" securities.[12/] Nor has the

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10/ Edgar v. MITE Corp., 102 Sup. Ct. 2629 (1982).

11/ See note 7, supra.

12/ For example, compare the statement in the 1980 Staff Report on Corporate Accountability, at the zenith of the Commission's interest in corporate governance, that "[t]he Commission...should consider carefully [pursuant to Section 19(c) of the 1934 Act] further suggestions for rule changes related to the internal corporate structure of listed companies, but, as a matter of policy, should not require such changes at this time" (see Division of Corporation Finance, Securities and Exchange Commission, Staff Report on Corpo-

(continued on next page)

present Commission been inclined to seek statutory amendments to cover in a comprehensive and consistent way all aspects of corporate governance that affect takeover contests or that might otherwise be considered of national concern.

The intertwined nature of what formerly might have seemed to be separable federal and state law concerns has become increasingly clear. I believe that the time has come for serious consideration of amendments to the 1934 Act to deal in a unified fashion with what can now be seen as interrelated happenings or problems. These amendments might not only provide Congress' answers to specific questions such as "greenmail" or abandonment of "one-share-one-vote," but should also serve to make clear the Commission's general authority over corporate governance questions that are of broad national concern, because of their intrinsic importance in relation to matters already committed to Commission regulation, because of the need for uniformity, or because of the desirability of avoiding a "race to the bottom" at the state level.

"Junk Bonds"; Bridge Loans.

The increased use of so-called "junk bonds" to finance either hostile takeovers, defensive restructurings or leveraged buy-outs is an important, and I believe somewhat worrisome, development of the recent past several months. There may be indications of a decline in their use since the Boesky affair became public, but this is far from clear.

(continued from previous page)
rate Accountability: A Re-examination of Rules Relating to Shareholder Communication, Shareholder Participation in the Corporate Electoral Process and Corporation Governance (September 4, 1980), 647) with a recent statement of Commissioner Charles C. Cox that for the Commission to exercise its authority over SRO rules concerning the one-share-one-vote issue or other corporate governance issues mentioned by him might be to "federalize corporate law to an unprecedented and...unintended degree" (see Charles C. Cox, Remarks to The New York Stock Exchange Legal Advisory Committee (December 19, 1986), 9).

More or less typical of the studies of specific topics conducted by the Commission's economists in recent years is a 1986 study ("Noninvestment Grade Debt as a Source of Tender Offer Financing") purporting to show that junk bonds have not had harmful effects and indeed may be considered an "innovative" form of financing.[13/] Junk bonds, of various degrees of "junkiness," may have their place, but a wider and deeper study of their potentially harmful impacts on issuers and investors (as well as on the national economy itself) might well lead to less benign conclusions than those arrived at by the recent narrowly-focused, econometric study. Institutional memory should remind the present Commission and staff that the first decades of the Commission's life were considerably devoted to rescuing and cleaning up an entire industry -- public utility holding companies and their subsidiaries -- that had been brought to the brink, or over the brink, of financial collapse largely as the result of excessively leveraged, pyramided capital structures.

The even newer phenomenon of bridge financing -- the investment banker lending enormous amounts of its own capital to facilitate deals on which it hopes to earn enormous profits and fees -- may turn out to be, on balance, both useful and beneficial. But before the balance is drawn, I believe there ought to be more thorough studies than appear to have been conducted, or to be in progress, as to the collateral consequences and implications of bridge financing, with regard to net capital risks and financial integrity of the lending firms as well as possibly broader structural impacts on the financial community.

Institutionalization and Automation; Program Trading.

Another cluster of issues arises from the vast progress in automation and vast increase in institutionalization that have occurred since the 1963 Special Study discussed the potential importance of both phenomena. Today, in comparison with 1963, computers perform many new functions and provide greatly increased speed, efficiency and economy in the performance of many old functions. Today, likewise, institutional block transactions tend to dominate

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13/ Office of the Chief Economist, Securities and Exchange Commission, Noninvestment Grade Debt as a Source of Tender Offer Financing (June 20, 1986), 10.

activity in the trading markets. In turn, many broker-dealer firms have been merged into larger entities or have been acquired by gigantic institutions capable of infusing unprecedented amounts of new capital.

These and other significant developments have greatly changed the market mechanisms, practices and problems that were the subjects of legislative or regulatory studies and actions in the Commission's first decade, and even in the 1960's. Such questions as floor trading, members' proprietary trading as bearing on their agency obligations, and the responsibilities of specialists, which were of major concern in those earlier periods, have yielded in importance to new questions such as the sheer massiveness of members' proprietary trading, the inter-relationships of equity markets and futures markets, and the new phenomenon of "program trading."

These new phenomena and new questions, which came into being as a result of unprecedented aggregations of capital and sophisticated new computer technology, obviously were not and could not have been dealt with through the legislative and regulatory initiatives of two or more decades ago. Yet program trading, to take one example, is seemingly contributing to unprecedented market volatility (notwithstanding the Commission staff's preliminary exculpation of index arbitrage program trading in this regard),[14] which in turn raises questions of fairness to, and confidence on the part of, the average public investors who formerly were the main market participants and the main objects of governmental concern.

It is certainly open to debate whether new regulatory measures are needed at this time. An activist, regulatory-minded Commission might give an affirmative answer, a more passive or deregulatory-minded Commission a negative answer. But whatever the answer, I do not believe that major new phenomena such as I have mentioned, with their possibly serious bearing on market volatility, market integrity, and investor confidence, should simply be taken for granted and allowed to go forward without appropriate regulatory scrutiny, or that such scrutiny can be confined to ex-post econometric studies, to the exclusion of ex-ante qualitative and policy-oriented approaches.

14/ Sec. Week, February 9, 1987, at 3.

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In the foregoing pages I have discussed a number of topics that I believe are in need of more systematic, analytical exploration or study -- I deliberately avoid the word "investigation" -- than they appear to have been receiving. There may well be topics on my list that do not really belong there, and there probably are other topics that might be added.

In any event, I wish to emphasize that the mere fact that I suggest a need for exploration or study does not necessarily mean that I see a need for regulatory action. Except with regard to certain aspects (including some corporate governance aspects) of takeover contests, I am not urging particular regulatory action on any particular subject; I am mainly saying that a possible need for regulatory action with regard to a new or emerging problem, to accomplish the objectives of the 1934 Act as set forth by Congress, should not be neglected for want of the Commission's having gained adequate familiarity and understanding of the subject through timely study and analysis.

III. The Respective Roles of Governmental Regulation and Self-Regulation.

The 1963 Special Study examined this topic in considerable depth. Its ultimate conclusion was that securities regulation "should continue to be based on the principle of giving maximum scope to self-regulation, wherever and to the extent that a regulatory need can be satisfactorily met through self-regulation," with government performing an oversight role vis-a-vis self-regulation as well as a direct regulatory role where self-regulatory authority and powers might not reach.[15]

Underlying that conclusion were two subsidiary conclusions of the Special Study: (i) that self-regulation with governmental oversight was more suitable, efficient and economical for most purposes than direct governmental regulation; and (ii) based on actual experience since 1934, self-regulation with governmental oversight, although in need of improvement in many respects, was generally working satisfactorily. I believe that, since 1963, there has in fact

15/ Special Study, Part 5 at 201.

Senator RIEGLE. Thank you, Mr. Cohen, we appreciate those comments and your full statement will be made part of the record.

Mr. Pitt.

STATEMENT OF HARVEY L. PITT, PARTNER, FRIED, FRANK, HARRIS, SHRIVER & JACOBSON

Mr. PITT. Thank you, Mr. Chairman. Senator Armstrong.

I am pleased to be here today to participate in your review of the functions, performance and legislative authorizations of the SEC. And I am also honored to be on the same panel with Milton Cohen and Jim Treadway.

In light of the time constraints, I will try to be even briefer than I had originally anticipated, and I might add, those who know me know that may be a difficult task for me, but I will try.

Senator RIEGLE. That is never a problem in the Senate. We are masters of summaries. We have the longest summaries that you have ever heard.

Mr. PITT. I do want to make clear at the outset that the views that I will be stating here today are solely my own. They do not necessarily reflect the views of other members of my law firm, many of whom take peculiar delight in contradicting some of my views, my law firm's current or past clients, the American Bar Association or any other entity with which I am now or have been affiliated. And since I have prepared a somewhat more detailed written comment, all I would like to do here is summarize a few basic thoughts and briefly describe ten legislative initiatives that I believe the subcommittee might wish to consider at this time.

At the outset, I do think it is important to state that in my view the Commission has, on balance, done an outstanding job under rather difficult circumstance. The suggestions that I will make for improving our current system are the product of my own concern that one of our most effective agencies should continue to function at the highest levels unencumbered by unnecessary budgetary, personnel and statutory restrictions.

In my opinion, the original concept of self-regulation embodied in the Securities Exchange Act is still fundamentally sound—namely—that governmentally supervised self-regulation is more effective than either self-regulation or Government regulation alone. The various self-regulatory organizations [SRO] should continue to bear primary responsibility for setting ethical standards for their members, a function for which I believe the SRO's are peculiarly well-suited.

Whether it still is appropriate for the various self-regulatory organizations to enforce more than their own ethical prescriptions, however, is a matter I believe is worthy of further consideration.

The role of the Government in the regulation of our securities markets is also worthy of renewed scrutiny and debate. While I believe that the deregulation, as it is called, of the early 1980's, played an important role in clearing away some unnecessary obstacles to securities market modernization, there are, as I will discuss, several areas where I believe new regulatory initiatives are required.

AREAS IN NEED OF ATTENTION

While I commend the Commission for doing an outstanding job with its critically limited resources, I believe that the Commission could better fulfill its mission if it concentrated upon several essential areas in which its attention is sorely needed, namely—the development of prompt and appropriate regulatory responses to new market developments, the protection of investors by prompt and scrupulous review of all key disclosure documents filed with the agency and the issuance of prompt, no action letters and interpretative releases to guide market participants desirous of complying with the law, but uncertain of its application to new products and unusual situations.

Although the Commission has had notable success in responding to certain market developments, the Commission has, in my view, failed to keep pace with other private sector innovation, such as those in the takeover arena, about which you heard this morning.

In recent times, takeover contests have been characterized by a variety of new techniques, some of which are highly questionable and patently unfair. They raise significant questions about the adequacy of the existing tender offer regulatory mechanism.

In addition, I believe that the Commission should emphasize the setting of clear standards by regulation, in lieu of lawmaking through enforcement proceedings. Nowhere is this more necessary than in the law governing insider trading. And while I commend the Commission's resourcefulness and its litigation successes in the lower courts in dealing with the recent *Chiarella* and *Dirks* decisions of the Supreme Court, and in pursuing a number of variations of the so-called misappropriation theory, the law that has resulted is somewhat tortured and of dubious validity, in my opinion. Even worse, as a result of these cases, legitimate businessmen face a fair amount of uncertainty in ascertaining the precise reach of the law and what steps they should take to assure compliance with it.

In short, I believe a happy balance should be struck between a program of enlightened deregulation, heightened enforcement and new regulatory initiatives that respond to carefully documented dysfunctions in the marketplace.

The Commission is surely capable of drawing the appropriate balance, although it has not always done so.

There can be little doubt that the Commission lacks both the resources and the remedies that are necessary if the agency is to deter securities law violations in the most efficacious manner.

I know that Senator Proxmire read this part of my statement, but it bears emphasis that the Commission has been saddled by budgetary constraints and a 6-year policy of enforced silence about those constraints and that the Commission is in danger of falling behind in the effort to police our securities markets.

While I am pleased that the Commission has decided to ask for additional funds and personnel, I am nevertheless concerned that the agency is seeking too little, too late.

SEC PERSONNEL

For many young professionals, the privilege of working at the SEC requires a financial sacrifice of as much as $40,000-a-year or more when compared with private sector salaries. And, even those who opt for Government service are surely cognizant, and may even be resentful, of the disparities in working conditions between life at 450 5th Street and life in the private sector.

No one can hope to equalize Government and private sector salaries. Nevertheless, it is intolerable that for SEC lawyers, virtue is not only its own reward, it has to be.

Of almost equal concern with the Commission's paucity of resources is its struggle to make do with remedies that do not always conform to the needs of a modern enforcement program. The Commission has generally utilized its arsenal of enforcement remedies in an incredibly effective manner, but the Commission's task could, and in my view should be, made considerably easier by clarifying some of the 50-year-old mysteries regarding the extent of its enforcement powers.

Prescribing legislative solutions to some of the problems I have pinpointed is undoubtedly a risky enterprise. The Commission has traditionally been chary of the legislative process, for fear that it will lose more than it gains; and it has found an all too willing ally in the private sector, which often fears emboldening an already formidable regulator and enforcer.

TIME RIPE FOR A COMPREHENSIVE STUDY

Nevertheless, I believe that the time is ripe for a comprehensive study of our markets, conducted by an independent committee commissioned by, and under the jurisdiction of, the Congress, with a view toward recommendations for new legislation and improved regulation, and consisting of industry participants, attorneys, congressional staff and representatives of the SEC.

In addition, since I believe some problems are manifest at this point, I propose the following 10 specific legislative initiatives, which I believe could resolve some of the more obvious rulemaking limitations and enforcement difficulties which plague the Commission.

One, the Commission's budgetary and manpower constraints should be alleviated by permitting the agency to fund its operations from the private sector, and to pay its employees a competitive salary above the current civil service scale.

Two, concomitantly, the Commission should be given the power to negotiate its own lease, free of the constraints imposed by budget limitations and the GSA.

Three, the Commission's rulemaking authority should be expanded to enable the agency to cope with changing investment products and changing security services.

Four, the substantive law applicable to insider trading should be overhauled to remove uncertainty, clarify the misappropriation theory and define the concept of insiders.

Five, the current legislation regarding tender offers and related corporate transactions should be overhauled to eliminate obvious

abuses and to conform the legislative scheme to the realities of today's markets and technologies.

Six, the Commission should be given cease-and-desist powers to enable the agency to deal with abusive conduct affecting the entire gamut of the securities laws.

Seven, the Commission's traditional injunctive authority should be clarified to confirm the SEC's authority to seek a whole host of equitable remedies.

Eight, the Commission's disciplinary authority over broker-dealers should also be clarified.

Nine, legislation should be enacted to encourage foreign governments to enter into formal cooperative ventures with U.S. law enforcement authorities to ensure mutual evidentiary assistance in cases of national importance.

Ten, finally, legislation should be enacted to authorize the SEC to require firms and professionals who are privy to market-sensitive nonpublic information to adopt meaningful guidelines.

I appreciate the subcommittee's time and this opportunity, and I will be happy to respond to any questions the subcommittee members have.

[The complete prepared statement of Harvey L. Pitt follows:]

been notable enhancement in the performance of the self-regulatory organizations (SROs), i.e., the national securities exchanges and the National Association of Securities Dealers, and substantial improvement in the Commission's continuous oversight thereof.

Accordingly, I would endorse today precisely the same principle (quoted above) that was enunciated by the Special Study in 1963 -- to give maximum scope to self-regulation in preference to direct governmental regulation wherever possible. However, tremendous changes that have occurred in the securities field since 1963 probably compel a quite different division of labor when this principle is applied today.

Changes in the Securities Field Since 1963.

Since 1963 many member firms have enlarged the scope as well as the size of their businesses; many new products are now dealt in, by these firms and in some instances also by other types of institutions such as banks and insurance companies; some competitive products are traded in markets that operate under different and often conflicting self-regulatory regimes, and even under separate and conflicting federal authorities (e.g., the SEC and the Commodities Futures Trading Commission (CFTC)), not to mention the Treasury Department, Federal Reserve Board, Comptroller of the Currency, etc.; more activities occur or are generated "upstairs," i.e., away from exchange floors, than ever before; and enormous advances in computer technology have led to more efficient, competitive and complex interrelationships among all markets, as well as more efficient means of communication and of surveillance (except, possibly, surveillance of "upstairs" activities within and among member firms).

Further, the financial community and the regulators are now confronted with increasing "internationalization" of the markets, and hence with the prospect of new levels of complexity in facilitating as well as regulating integrated round-the-clock operations. To what extent internationalization will require relaxations of domestic controls, extensions of domestic controls internationally, or even -- at a governmental level beyond the scope of domestic and foreign securities regulators as such -- the negotiation of treaties to achieve greater uniformity in the domestic laws of participant countries (e.g., commercial codes or bankruptcy laws that would underlie international clearance arrangements) remains to be seen.

The Self-Regulatory Role in 1963 and Presently.

In 1963 each SRO conducted a separate market and its self-regulatory responsibility related primarily to activities within that market. (Of course, there were great variations in the nature and size of markets, and scope of self-regulatory responsibilities, among the different SROs.) In addition, the several SROs, separately or in collaboration, carried out surveillance and enforcement activities with regard to some off-floor matters, such as net capital rules, margin rules, and selling practices, involving their considerably overlapping memberships.

Since 1963, the traditional regulatory responsibilities of the SROs, as discussed in the Special Study, have not been declining but may in fact be increasing. The SROs obviously must continue to be primary regulators of behavior within their own marketplaces and, separately or in cooperation with each other and with the Commission, they must continue to aid in the policing of some activities outside of their marketplaces (both of which tasks have become more complicated); they must constantly amend and expand their rules to cover new products and new competitive conditions, and must consider the relationship of their rules to those of SROs that conduct competitive markets, including markets in more-or-less competitive products within the authority of the CFTC or other agencies; and at least some of them can and should be expected to make their own studies, or aid in Commission studies, concerning new phenomena or practices that may require consideration of regulatory action at the self-regulatory level or the governmental level.

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Thus far I have referred only to the SROs as bearing the burden of industry self-regulation. Actually, the starting point must be the individual firm. It is my impression that since 1963 there has been a general strengthening of the firms' compliance departments, but in some notable cases apparently not enough, or perhaps not with a broad enough conception of the firms' total responsibility for the conduct of their personnel.

In 1963, selling practices and supervision thereof were the main focus of attention in discussions of the self-regulatory responsibilities of individual firms. That area of concern, affecting the brokerage or agency side of the business, seems to have been brought under much better

control. It has been succeeded in importance by new concerns regarding proprietary (principal) trading, of many sorts, both for firm accounts and for the accounts of individuals within the firms. Recent examples of flagrant abuses in these areas demonstrate that in many individual firms, including some very important and highly-regarded ones,' their internal rules and standards of conduct, as well as their machinery for supervision, surveillance and detection of violations, are seriously in need of re-examination, under the guidance and prodding of the SROs and ultimately of the SEC, so as adequately to address proprietary trading activities.

Beyond these apparent deficiencies relating specifically to proprietary trading (and probably other changed market circumstances of today), some firms obviously have been neglecting their fundamental self-regulatory obligation to seek to assure that all of their business is conducted, not only in accordance with legal requirements, but also ethically, honestly, and in accordance with "just and equitable" principles. The firm itself -- not a more remote SRO or even more remote SEC -- is in by far the best position to assure that only persons of character and integrity (entirely apart from their qualities of intelligence, imagination, charisma, or whatever) are brought into the business and kept in the business. No techniques for assuring character and integrity are foolproof, but it is clear that gross deficiencies in these basic qualities have surfaced far more frequently than the securities business or its regulators can justify or tolerate.

The Governmental Role.

Despite the expanded field of SRO responsibility, much of the total expanded field of potential securities regulation -- particularly in areas where inter-agency action or international action may be essential, or where non-members as well as members of SROs may be involved -- is basically beyond the reach of the SROs and must be the Commission's own direct concern. Further, the Commission must take primary responsibility where investigations or enforcement actions may require a formal subpoena power or an ability to collaborate with criminal prosecutors, e.g., with regard to grants of immunity. The enlarged and more complex nature of these latter matters, together with enlarged SEC oversight responsibilities with regard to broadened SRO activities, inevitably mean that the government's role will be greater in relation to the role of the SROs than might have been the

case when the Special Study recommended the basic division of labor mentioned above.

In summary, (1) the total field that is now within the potential scope of the regulatory provisions of the 1934 Act is considerably larger and more complex than in 1934 or even in 1963; (2) many if not most of the new phenomena that account for the greater size and complexity of the field are probably beyond the effective reach of the SROs themselves and (if any regulatory action is indicated) must be dealt with governmentally; and (3) therefore, while the principle of "giving maximum scope to self-regulation, wherever and to the extent that a regulatory need can be satisfactorily met" should continue to apply, the Commission's share relative to the self-regulatory share of the total regulatory burden must probably be larger than heretofore.

IV. Adequacy of Commission Resources.

My general impression concerning the adequacy of the Commission's resources to carry out its responsibilities is that they are inadequate, and seriously so. More specifically --

(1) While this comment is outside the boundary that I set for my remarks today, I believe that the Commission should have additional funding for the implementation of EDGAR, the proposed automated facility for the integrated corporate disclosure system. A strong corporate disclosure system is basic to the entire field of operation and regulation of securities markets, and I strongly agree with the Commission that enhancement of the system through computerized means of furnishing and retrieving information should be a very high priority.

(2) The resources of the Enforcement Division (and of the regional offices in carrying out their share of the enforcement effort) are severely strained and very likely will become more so. Substantial additions to personnel, and probably also to automated means of detection, are needed if prevention or prosecution of insider trading and other unlawful activities continues to be a major goal.

(3) The Division of Market Regulation (and very likely other administrative divisions) are seriously understaffed, in numbers as well as experienced personnel, just in relation to the Division's heavy, continuous workload in reviewing SRO rule filings and outside comments thereon;

preparing its own rule proposals and reviewing comments thereon; responding to Congressional inquiries; dealing with divisions of jurisdiction between the SEC and other regulatory agencies, or among Congressional committees; and performing other "routine" but essential functions. The subject matters of the Division's work are extremely varied and extremely complex and esoteric. Because of high staff turnover, new filings and other routine business must often be assigned in the first instance to relatively inexperienced and non-knowledgeable newcomers to the staff. I believe that substantial additional funding is needed, not merely to permit an expansion of numbers but also, and more important, to permit hiring and retention of individuals having some familiarity with the subject matters as well as reasonable capability to make expert and mature judgments on policy issues.

(4) Throughout this Statement I have referred to the need, in my opinion, for deeper or more systematic studies of various sorts of developments that are new or still emerging, that may not be adequately covered by existing regulatory measures, but that may call for affirmative regulatory action either now or in the foreseeable future. I have also said that the typically narrowly-focused, statistical studies that are done from time to time by the Commission's Directorate of Economic Policy and Analysis or the Office of the Chief Economist are not sufficient. I would say the same, for different reasons, about the Commission's occasional roundtable discussions or invitations for public comments about possible rule changes or "concept releases" on various topics. To perform the kinds of studies that may be needed, I believe that adequately experienced and knowledgeable individuals, capable of conducting sound and thorough studies and arriving at mature qualitative judgments, must either be taken from the existing staff (and freed up from more routine work) or else must be brought in specially from outside.

Providing the necessary personnel can be accomplished in a number of ways, including (i) what was done in 1961, i.e., bringing together a temporary, full-time staff for a specified period, perhaps a year or more;[16/] or (ii)

16/ The Special Study staff consisted of some 70 full-time individuals, professional and non-professional, assisted by a number of individuals borrowed part-time from the regular staff. Nearly two years elapsed from the beginning of the effort until its completion. However, I am not suggesting that these particulars would necessarily provide an appropriate model for the future.

alternatively, as recommended by the Special Study, creating a smaller, permanent "policy and planning unit" for the Commission as a whole, or separate units for one or more of the operating divisions -- especially the Division of Market Regulation -- that might take up different topics from time to time (somewhat in the manner of the present Directorate of Economic Policy and Analysis but not staffed primarily by economists of the "Chicago school" or the econometric school).

Such an addition to the Commission's resources, in addition to those referred to in the preceding paragraphs, is in my opinion essential, and I suggest the Commission's budget and appropriations should be expanded accordingly.

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WRITTEN STATEMENT OF HARVEY L. PITT,
BEFORE THE SECURITIES SUBCOMMITTEE OF
THE SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE,
REGARDING THE SECURITIES AND EXCHANGE COMMISSION

(February 24, 1987)

Mr. Chairman, Members of the Subcommittee:

Introduction

I am pleased to have this opportunity to appear before you today to express my views during your review of the functions, performance, and legislative authorizations of the Securities and Exchange Commission (hereinafter referred to as the "SEC" or the "Commission"). Although the views I will present today are solely my own, I think it appropriate to set forth, as a matter of my own full disclosure of the sources of my prejudices in this area, my background and involvement in the matters the Subcommittee will be considering.

I am a partner in the Washington Office of Fried, Frank, Harris, Shriver & Jacobson, a 325-attorney law firm, with additional offices in New York City, Los Angeles and London. I have been a partner at Fried, Frank for nearly nine years, and serve as the chairman of the Washington office's corporate department, and co-chairman of the Washington office's management committee. I am the Chairman of the Subcommittee on SEC Practice and Enforcement of the American Bar Association's Committee on Federal Regulation of Securities, and I am Co-Chairman of the Subcommittee on State Takeover Laws of the American Bar Association's Committee on State Securities Regulation.

Prior to joining my law firm in 1978, I had the privilege of serving on the staff of the SEC for over a decade, during the last three years of which (from 1975 to 1978) I was the Commission's General Counsel. Prior to that appointment, I served, among other things, as the Chief Counsel of the Commission's Division of Market Regulation, and as an Editor of the Commission's Institutional Investor Study. I was also privileged to serve as the Executive Assistant to then-Chairman Ray Garrett, Jr., and as a Legal Assistant to former Commissioner Francis M. Wheat.

I should also note that I and my law firm have represented, and presently are representing, a number of clients with interests in the securities industry, including domestic and foreign financial institutions, investment banking firms, investment companies, broker-dealers, and arbitrageurs. I want to stress, however, that the views I will state here are solely my own; they do not necessarily reflect the views of other members of my law firm, my law firm's current or past clients, the American Bar Association, or any other entity with which I am (or have been) affiliated.

I have organized my testimony into the three major topics outlined by Chairman Riegle in his letter of invitation:

1. What should be the role of the government in regulation of the securities markets and what should be the role of self-regulation?

2. What, if anything, should the Commission be doing which it is not presently doing and what improvements, if any, would you recommend making in the regulation of the securities markets?

3. Does the SEC currently have adequate resources to do its job correctly and adequate remedies to deter securities law violations?

Summary of Views

My conclusions can be briefly outlined as follows:

- The Commission needs to focus on two primary goals: facilitating capital formation and ensuring market integrity.

- Self-regulatory organizations should bear primary responsibility for setting ethical standards for their members. Further evaluation is required, however, as to the best means to enforce these standards. The Commission should establish applicable legal norms by rulemaking rather than by enforcement proceedings and civil litigation; the latter should be used, of course, to enforce and implement the Commission's fairly-applied, existing rules.

- While the Commission has done an outstanding job with its critically-limited resources, it has not been able to concentrate upon several essential areas in which the Commission's attention is sorely needed.

  -- developing prompt and appropriate regulatory responses to new market developments;

  -- protecting investors by promptly and scrupulously reviewing disclosure documents; and

  -- guiding market participants by issuing prompt no-action letters and interpretive releases.

- The time is right for a comprehensive study of our markets, conducted by an independent committee commissioned by, and under the jurisdiction of, the Congress, with a view toward recommendations for new legislation and improved regulation.

- In addition, I am proposing ten specific legislative initiatives to resolve quickly some of the rulemaking limitations and enforcement difficulties which currently plague the Commission, including its budgetary constraints.

Background

In addressing the three issues posed by the Subcommittee, it is useful to bear in mind that the unique strength of our capital markets is their attractiveness to investors worldwide, whether individuals or institutions, and the confidence demonstrated by these investors as they supply capital to companies and governments looking for their financial support. Economic liquidity and efficiency are major factors in achieving this level of confidence, and political stability is also a contributing element, but it is crucial not to underestimate the importance of market integrity in promoting investor confidence.

The SEC plays a critical role in preserving investor confidence in the integrity of our capital markets, and its efforts may be the single most important factor responsible for their success. We should not take that success for granted; other markets, such as the London Stock Exchange, for example, are seeking to improve their competitiveness with United States markets, and any shifting of international investor activity to other markets could reduce our "invisible exports" of financial services.

For all these reasons, it is disturbing that the public's belief in the integrity of our securities markets may be subject to some erosion and confusion, due to the events that have been reported almost daily in the press over the last few months. Consequently, today's hearing, and the hearings to follow, take on added significance. This is clearly an appropriate time for the Congress to consider the adequacy of our current legislative and regulatory scheme. Because I conclude that there is an appropriate basis for strengthening our current system, I will recommend ten specific legislative initiatives that I believe this Subcommittee should consider.

1. What should be the role of the government in regulation of the securities markets and what should be the role of self-regulation?

At least in the context of securities regulation, I find attractive Justice William Douglas' view of relying initially on private sector self-regulatory authority, and preserving the "shotgun" of more direct government intervention "behind the door, well oiled, cleaned, ready for use but with the hope it would never have to be used."[1/] The balance struck by Congress in the Securities Exchange Act of 1934[2/] between governmental regulation and self-regulation of the nation's securities markets remains fundamentally sound, in my opinion, but worthy of careful reconsideration and fine-tuning.

In evaluating the proper balance between government and self-regulation, proponents of the 1934 Act considered that "nonlegal, quick acting, nonreviewable disciplinary measures which an exchange [could] take, [could] never be adequately replaced by the slower moving processes of an administrative agency or the courts."[3/] Although Congress acknowledged that

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1/ W. Douglas, Democracy and Finance 64-65 (J. Allen, ed. 1940).

2/ Act of June 6, 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78jj (1982) (the "1934 Act")).

3/ Report to the Secretary of Commerce of the Comm. on Stock Exchange Regulation, 73d Cong., 2d Sess. 12 (1934).

self-regulation alone would not accomplish all regulatory goals,[4] it adopted government-supervised self-regulation as more effective than either self-regulation or government regulation alone.[5] That notion has been repeatedly reaffirmed: in 1938, with the passage of the Maloney Act;[6] in 1964, with the passage of the statutory amendments that were generated by the SEC's landmark Special Study of the Securities Markets;[7] and again about forty years after the Commission was established, with the passage of the Securities Acts Amendments of 1975.[8]

The notion underlying industry self-regulation then, as now, was that the industry could do a better job of articulating ethical standards for its various individual and institutional components than could the government. When market participants are able to regulate themselves, their expertise in the detailed workings of the marketplace enhances the prospect of developing ethical guidelines that will work. Honest evaluation of market problems by those who participate daily in the marketplace provides the best basis for creating guidelines effectively addressing those problems.[9] Even

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4/ See Silver v. New York Stock Exchange, Inc., 373 U.S. 341, 350-54 (1963).

5/ Stock Exchange Regulation: Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 544 (1934).

American stock exchanges had regulated the conduct of their members for decades prior to the adoption of the 1934 Act, but the 1934 Act imposed government supervision of this self-regulation. Miller, Self-Regulation of the Securities Markets: A Critical Examination, 42 Wash. & Lee L. Rev. 853, 869 (1985).

6/ Act of June 25, 1938, ch. 677, 52 Stat. 1070.

7/ Securities Act Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565.

8/ Pub. L. No. 94-29, 89 Stat. 97 (Jan. 4, 1975).

9/ Similarly, the self-regulatory organizations are in a unique position to notice when unfair trading practices occur. Sophisticated computer programs implemented by the exchanges and by the National

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today, with the media questioning the ethical precepts by which the various constituents of the securities industry function, entrusting the development of ethical standards to industry self-regulators makes a great deal of sense, provided, of course, that the industry's self-regulators dedicate themselves to the important tasks at hand, and satisfy the public that they are capable of performing this undertaking effectively and on a timely basis, as I believe they are.

Nevertheless, despite my general faith in the concepts of industry self-regulation embodied in the federal securities laws, there are a number of problems with the current system of supervised self-regulation. For one thing, both domestic and international markets have grown far more competitive within the last decade. While this rivalry has brought innovation to the marketplace, it has, on occasion, reduced the self-regulators to competitive machinations more appropriate to private-sector, profit-making enterprises than industry self-regulators. The recent maneuvering over the "one-share, one-vote" controversy is a good example of this problem.[10]

Moreover, in the disciplinary arena, I harbor a continuing concern, based upon my own experiences as an attorney who has

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9/ Footnote Continued From Previous Page

Association of Securities Dealers, Inc. (the "NASD") within the past twenty years can spot trading irregularities as they occur, affording the self-regulators and the SEC the best opportunity for maintaining the integrity of the marketplace by quick enforcement action.

10/ The New York Stock Exchange, Inc. ("NYSE") proposed a rule change that would allow its listing of issuers that have multiple classes of common stock with disparate voting rights. Exchange Act Release No. 23,724 (Oct. 22, 1986), 51 Fed. Reg. 37,529. The NYSE proposal was prompted by the threats of NYSE-listed companies (some of which have already adopted common stock structures with disparate voting rights) to delist and become traded on the NASD's Automated Quotations System ("NASDAQ") if the NYSE did not adopt such a proposal. NASDAQ does not set standards in this area. The Commission held a public hearing on this proposal, but has not yet announced whether it will permit the rule change to take effect.

represented clients before the various exchanges and the NASD, as well as my experiences as an attorney representing self-regulators, that the self-regulators are, on occasion, subject to a host of political, regulatory and competitive pressures, not necessarily of their own making, that can prevent them from fairly assessing the merits of a particular disciplinary proceeding. The uneven quality of these enforcement proceedings leaves me with a distinct concern that standard-setting, rather than standard-implementation, is the strong suit of the various self-regulatory organizations.

The role of the government in the regulation of our securities markets is itself worthy of renewed scrutiny and debate. At the time the SEC was created, both the Congress and the public placed a great deal of faith in "involved governmental regulation." Comprehensive legislation was the hallmark of the New Deal, out of which the Commission was born. Over the years, however, we have grown to question whether such detailed regulation is sensible, and I believe there was broad support for the policies of deregulation that marked the beginning of our current decade. Excessive regulation can stifle creativity and innovation; particularly in the present climate of increasing internationalization of the world's securities markets, excessive regulation (by the SEC or anyone else) is an evil that surely should be avoided.

The difficulty arises when a government agency or self-regulatory organization, having determined not to proceed by regulation, instead seeks to develop normative standards in the context of enforcement proceedings or civil litigation. Lawmaking by enforcement, in particular, is a troublesome concept, especially for those who may find themselves thrust in the role of "test" cases. Enforcement proceedings are punitive in nature, and are not an appropriate means of promulgating "new law." Zealous prosecutors occasionally have difficulty in drawing meaningful distinctions between the use of enforcement proceedings to deal with clear violations of existing law, and their use to promulgate policy pronouncements reflecting their view of what the law should be.11/

11/ An example of this can be seen in Dirks v. SEC, 463 U.S. 646 (1983), where the Supreme Court reversed an SEC enforcement action against Raymond Dirks. Dirks, having learned of an issuer's fraud from its former employee and having failed to persuade the SEC or the Wall Street Journal to investigate the matter, advised his clients of the information, sparking a sell-off.

Footnote Continued

In short, a happy balance must be struck between a program of enlightened deregulation, heightened enforcement and regulatory initiatives that respond to carefully documented dysfunctions in our marketplace. The Commission is surely capable of drawing the appropriate balance, although it has not always done so.

In this context, it should be noted that the three major legislative initiatives involving federal securities legislation were each preceded by major studies of our capital markets. Prior to the passage of the Securities Exchange Act in 1934, the Senate Banking Committee, guided by its counsel, Ferdinand Pecora, conducted a sweeping review of our markets and the abuses that infected them.12/ Prior to the passage of the 1964 amendments to the federal securities laws, Milton Cohen led a blue-ribbon group of outstanding young lawyers in the seminal Special Study of the Securities Markets, a monumental work that remains today as the most comprehensive and insightful evaluation of our market systems.13/ And, prior to the adoption of the detailed Securities Acts Amendments of 1975, this Subcommittee conducted a three-year review of our markets and the Commission's regulation of

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11/ Footnote Continued From Previous Page

The Court rejected the SEC's novel theory for Dirks' liability in that matter, holding that the Commission's Rule 10b-5 cannot be read to bar trading on undisclosed material inside information by a corporate outsider who owed no fiduciary duty to disclose or refrain from trading. As the Dirks case indicates, not only are efforts to make new law through enforcement proceedings unfair, they are also frequently unsuccessful.

12/ Stock Exchange Practices: Hearings Pursuant to S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 (73d Cong.) Before the Senate Comm. on Banking and Currency (1932-1934) (frequently referred to as the "Pecora Hearings").

13/ SEC, Report of the Special Study of Securities Markets, H. Doc. No. 95, 88th Cong., 1st Sess. (1963) (the "Special Study").

them.14/ I am not alone in calling for a major review of our markets with a view toward recommendations for new legislation and improved regulation.15/ This does not mean that all legislative efforts should be deferred, but it does mean that Congress should direct a new Special Study, or Pecora Hearing, to provide it with with the factual predicates required for a comprehensive reassessment and updating of our system of market regulation.

2. What, if anything, should the Commission be doing which it is not presently doing and what improvements, if any, would you recommend making in the regulation of the securities markets?

Responding fully to the question -- what should the Commission be doing that it is not currently doing? -- runs the risk of sounding unduly critical about an agency that I believe is doing a first-rate job under adverse conditions. Accordingly, I preface my response to the Chairman's second question by noting that the Commission has performed admirably in the face of unconscionable budgetary and manpower constraints. And, it is difficult to suggest improvements in the regulation of the securities markets without alienating one or another interest group. Nevertheless, there are a number of important areas where I believe the Commission, with adequate resources, could be doing more than it currently is doing.

For much of the Commission's history, it has declined to view its proper role as including the facilitation of capital formation in the United States. While the Commission has, in recent years, taken a more enlightened view of its mission, it has yet to embrace this particular goal in a whole-hearted fashion.

14/ Securities Industry Study: Report of the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, S. Doc. No. 13, 93d Cong., 1st Sess. (1973).

15/ The Honorable Stanley Sporkin, former SEC enforcement chief, has been outspoken recently in suggesting the need for a new comprehensive study, patterned after the Special Study. Ingersoll, "Democrats in Congress Aim To Curb Takeover Excess," Wall St. J., Feb. 17, 1987, at 30, col. 1.

A well-informed market is critical to capital formation, and the Commission's decision to forego traditional review procedures for important disclosure documents, because of the failure of the agency to staff its regulatory divisions adequately, is a significant agency shortcoming. For example, in 1975 the Commission reviewed every Securities Act of 1933 ("1933 Act") registration statement, whether from a new or repeat issuer. It also reviewed every annual meeting proxy statement and every annual, quarterly and current report.16/ In 1986, the Commission reviewed only 72 percent of the new-issuer 1933 Act registration statements. Also for that year, the Commission reviewed only 27 percent and monitored only 22 percent of repeat-issuer 1933 Act registration statements, reviewed only 19 percent and monitored only 6 percent of all annual meeting proxy statements filed, reviewed only 17 percent and monitored only 4 percent of all annual reports filed, and reviewed only 5 percent and monitored only 22 percent of all quarterly and current reports filed with the Commission. While the Commission increased its 1933 Act registration statement reviews significantly during 1986 from those accomplished in 1985, other categories did not show significant change and the Commission predicts no additional improvement during the years 1987 and 1988.17/

Similarly, capital formation may be impeded when market participants considering capital-raising methods that present new legal issues are unable to obtain important no-action advice in a timely manner because of inadequate Commission staffing. Although the Commission staff makes every effort to be responsive, there are often significant delays in the no-action process due to budgetary and staffing limitations.

The Commission has had mixed results in its efforts to keep pace with market developments and create appropriate regulatory responses to those developments. On the one hand, the Commission has been very successful in dealing with the internationalization of securities markets, successfully negotiating, for example, memoranda of understandings with

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16/ SEC Budget Estimates for Fiscal 1977.

17/ SEC Budget Estimates for Fiscal 1988 I-10, 11 (all figures are rounded to the nearest percent).

foreign governments and associations on the exchange and release of information.18/

On the other hand, the Commission has been ill-equipped, in the best of circumstances, to keep pace with rapid private sector innovations in the takeover arena. In recent times, takeover contests have been characterized by a variety of new techniques, some of which are highly questionable and patently unfair, that raise significant questions about the adequacy of the existing tender offer regulation mechanism.

Thus, for example, the Commission's failure to respond to unconventional "tender offers," creeping acquisitions, untimely Schedule 13D filings, open market acquisition programs, greenmail, "poison pills" and the like, have left the securities markets volatile and inflamed, in many instances, often to the detriment of the investing public. The fever pitch with which our markets put company after company "in play" -- Wall Street's terminology for the inevitable demise of a company's independence, in many cases without apparent rationale -- has distracted corporate managements and caused an undue focus on short-term profitability. This, in turn, has had a lasting negative effect on our international competitiveness, as research and development, capital investment, quality control, and other activities that pay long-term dividends have been pared in the name of short-term financial performance.

To be sure, in some circumstances the Commission has resorted to enforcement proceedings and amicus curiae participation in private civil litigation to articulate its views of what the tender offer law is, or should be. These are, in the best of circumstances, poor substitutes for an effective regulatory system. In fact, these efforts are no

18/ See, e.g., Memorandum of Understanding on Exchange of Information Between the United States SEC and the United Kingdom Department of Trade and Industry in Matters Relating to Securities . . . (September 23, 1986); Memorandum of Understanding Between the Government of the United States of America and the Government of Switzerland (August 31, 1982); and Agreement XX of the Swiss Bankers Association with Regard to the Execution of Requests for Information from the Securities and Exchange Commission of the United States on the Subject of Misuse of Inside Information (July 24, 1982).

substitutes at all, since the courts have rejected a variety of Commission positions articulated in this vein, in some cases because of the Commission's unfinished rulemaking agenda.19/

The Commission's budgetary and manpower constraints have also hampered a number of other programs the Commission should be pursuing in the public interest. Among these is the Commission's program of broker-dealer and investment adviser inspections, where the Commission's current record is decidedly inadequate.20/

As I mentioned previously, the Commission's traditional focus on enforcement, often as the exclusive vehicle for policy formulation, has continued in this era of deregulation with disturbing frequency. For example, the SEC's heavy reliance on its enforcement powers to deal with situations many years old, where accounting techniques and financial statements do not

19/ See, e.g., SEC v. Carter Hawley Hale Stores, Inc., 587 F. Supp. 1248 (C.D. Cal. 1984), aff'd, 760 F.2d 945 (9th Cir. 1985), in which the SEC sought an injunction barring a target company from repurchasing its own stock in an attempt to defeat a takeover attempt. The federal Court of Appeals for the Ninth Circuit upheld the District Court's determination that the repurchase did not constitute a self-tender offer, a result which might have been avoided had the SEC promulgated prospective regulations rather than attempting to make law through litigation. See also Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986 (en banc), rev'g Hanson Trust PLC v. SCM Corp., 774 F.2d 47 (2d Cir. 1985) (court rejected SEC amicus curiae position that Hanson Trust's purchase of shares from six sellers immediately following termination of its tender offer for SCM constituted a tender offer within the meaning of Section 14(d) of the 1934 Act).

20/ In 1986, the Commission carried out routine oversight examinations of only 481 of the 11,688 registered broker-dealers (4.1%) (plus cause examinations of 69 brokers-dealers, or 0.6% of the total) and 1,263 of the over 9,000 registered investment advisers (14%). See SEC Budget Estimate Fiscal 1988 (January 30, 1987) at III-2, 3 and IV-3, 5. The registered broker-dealers, at least, are also subject to inspection by the self-regulatory organizations; the investment advisers are not.

conform to the views of the agency's staff accountants and lawyers, has produced a series of lengthy and costly investigations, with no apparent public benefit when the cases are finally made public upon the inevitable announcement of a settlement, many years after the events under investigation occurred.

The Commission's timidity in using its significant regulatory powers, rather than its arsenal of enforcement weapons, to assist Corporate America and the accounting profession in the setting and application of financial accounting standards is unfortunate. Similarly, the Commission's reluctance to return to Congress to ask for legislation to deal with anomalies in the current state of the law is regrettable. Instead, the agency has been content to rely upon case-by-case litigation as the device by which the Commission seeks to overcome troublesome precedents with which the agency has been saddled. The result has, on occasion, been public confusion about precisely what conduct the Commission believes violates the law, and a series of judicial decisions that only serve to make the Commission's task all the more difficult.

Nowhere is this more true than in the law governing insider trading, where the Commission's law enforcement role has been rendered more difficult by two major Supreme Court decisions with which this Subcommittee is quite familiar -- the Chiarella[21/] and Dirks[22/] cases. While I commend the Commission's resourcefulness and its litigation successes in dealing with these decisions, and in pursuing a number of variations of the so-called "misappropriation" theory to support the agency's insider trading allegations, the law that has resulted is somewhat tortured, and of dubious validity, in my opinion,[23/] even worse, as a result of these cases

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21/ Chiarella v. United States, 445 U.S. 222 (1980).

22/ Dirks v. SEC, supra n.11.

23/ The problems with the misappropriation theory are clearly illustrated in the present Supreme Court case of United States v. Winans (which, of course, is a criminal case brought by the U.S. Attorney and not by the SEC). It is ludicrous that in that case, which involves a former Wall Street Journal reporter who allegedly gave trading tips in reliance on the expected publication dates of press columns involving

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legitimate businessmen face a fair amount of uncertainty in ascertaining the precise reach of the law and what steps they should take to assure compliance.

Finally, a word or two should be added about the Commission's two significant regulatory failures -- the regulation of all financial instruments, irrespective of the nomenclature appended to such instruments, and the agency's attempt to regulate securities brokerage services along functional lines, irrespective of the particular purveyors of such services or their owners. In both of these instances, the Commission was on the right track, and it should be given the legislative authority to achieve its objectives.

In the financial instruments area, artificial lines have been drawn between largely indistinguishable financial futures and financial options, and the Commission has been denied jurisdiction over the former. As an historical matter, this resulted from a 1982 compromise between the Commission and the Commodities Futures Trading Commission ("CFTC"), later ratified by Congress,[24/] which was sparked, at least in part, by a

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23/ Footnote Continued From Previous Page

the securities in question, liability under the federal securities laws should hinge, as the lower courts held under the judicially-developed "misappropriation theory," on whether the Wall Street Journal had an announced policy favoring or opposing such activity. 612 F. Supp. 827 (S.D.N.Y. 1985), aff'd in part and rev'd in part sub nom. United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), cert. granted, 107 S. Ct. 666 (1986). See also the discussion of Dirks v. SEC, supra n.11.

24/ The agreement between the SEC and CFTC ("SEC/CFTC Jurisdictional Accord") clarified that the Commission had jurisdiction over put and call options on exempt and nonexempt securities, certificates of deposit, groups or indices of securities, and, when traded on a national securities exchange, foreign currency, and that the CFTC had jurisdiction over futures contracts on exempt securities, certificates of deposit and broad-based indices of securities, as well as over options on futures and options on foreign currencies traded on a commodities exchange. See Exchange Act Release No. 19,125 (October 14, 1982), 47 Fed. Reg.

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lawsuit brought by the Board of Trade of the City of Chicago ("CBOT") challenging the Commission's approval of trading of GNMA options on the Chicago Board Options Exchange, Incorporated.[25/] This has continued to be a troublesome area for the Commission since bifurcation of the markets in this manner makes little sense.

Similarly, it is inconsistent with sound regulation and investor protection that securities discount brokerage services purveyed by depositary institutions and their subsidiaries are not subject to the same regulatory structure as those supplied by securities brokers and dealers registered with, and regulated by, the Commission.

In the Glass-Steagall Act[26/] and other securities and banking laws, Congress sought to erect high walls between the banking and securities industries, assigning to the SEC jurisdiction over the latter. However, as indicated by the increasingly important role of depositary institutions in the

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24/ Footnote Continued From Previous Page

46,934. This was ratified by Congress in amendments to the 1934 Act and the definitions of "security" in other federal securities laws (Act of Oct. 13, 1982, Pub. L. No. 97-303, 96 Stat. 1409 (often referred to as the "Securities Acts Amendments of 1982")), and by amendments to the Commodities Exchange Act (Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294).

25/ The Congressional action led the Supreme Court to vacate the decision by the federal 7th Circuit Court of Appeals that the Commission lacked jurisdiction over GNMA options. CBOT v. SEC, 677 F.2d 1137 (7th Cir. 1982), and No. 81-2587 (7th Cir., Mar. 24, 1982) vacated, 459 U.S. 1026 (1982). A subsequent challenge by the CBOT of joint SEC/CFTC guidelines on options and futures on narrow-based stock indices was dismissed as unripe. CBOT v. CFTC and SEC, Civ. 188 Act. No. 84C1141, Fed. Sec. L. Rep. (CCH) ¶ 91,437 at 98,188 (N.D. Ill., March 30, 1984).

26/ Sections 16, 20, 21 and 32 of the Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended at 12 U.S.C. §§ 24 (Seventh), 377, 378, 78 (1982 & Supp. III 1985)).

securities discount brokerage area, for example, these walls have become an ineffective barrier, prompting one commentator to term the Glass-Steagall Act "the Maginot Line of finance."[27/]

Noting the increasing importance of banks in the securities industry as a result of the emasculation of the Glass-Steagall Act, the SEC determined in 1985 that the concept of "broker-dealer" should be altered to reach those banks acting as broker-dealers, and therefore promulgated Rule 3b-9.[28/] The rule followed the premise that the SEC should regulate institutions based upon their financial function rather than their character or "species." Since banks were acting out of character, functioning as broker-dealers, the SEC reasoned that these actions removed from them the definitional shield from SEC regulation ordinarily afforded to commercial banks. The federal Court of Appeals for the District of Columbia Circuit has invalidated Rule 3b-9, and it is unclear whether this decision will be reviewed by the Supreme Court.[29/]

In both of the foregoing instances, the financial futures/options dilemma and the banking broker-dealer definition, the Commission's justifiable efforts to exercise regulatory jurisdiction have been rebuffed by the courts. Both of these matters are worthy of revisitation and corrective action by the Congress.

27/ Statement of James Robinson, Chairman and Chief Executive Officer of the American Express Co. before the Securities Industry Association's annual meeting Dec. 4, 1986, quoted in Horowitz, "Glass-Steagall's Demise is Predicted; Auguries by American Express Chief, Several Others Dismay SIA," Am. Banker at 3, Dec. 5, 1986.

28/ 17 C.F.R. § 240.3b-9 (1986).

29/ See American Bankers Association v. SEC, 804 F.2d 739 (D.C. Cir. 1986). As a matter of practice, the SEC cannot successfully petition for Supreme Court review without the affirmative support of the Solicitor General. In disputes that divide federal agencies, as this one does, that support is invariably withheld.

Senator RIEGLE. Thank you, Mr. Pitt.
Mr. Treadway.

STATEMENT OF JAMES C. TREADWAY, JR., PARTNER, BAKER & BOTTS

Mr. TREADWAY. Mr. Chairman. Thank you. I too am honored to appear before this committee, subcommittee, as well as to sit with Mr. Pitt and Mr. Cohen, distinguished practitioners, and I too will try to be very, very brief in my summary.

First of all, let me go directly to the questions that were posed in your letter. One was of the relative roles of governmental versus self-regulation. My comments constitute, essentially, an endorsement of the system, the structure that is in place. I went on, however, to point out a number of impediments that exist for self-regulatory organization.

I would simply refer you to my comments, but I would like to add just a couple of other thoughts, that when you get down to an assessment, regulation versus self-regulation, I pointed this out in my full statement, that the debate ought not to be a disguised debate about the level of regulation. If the particular regulation is too extreme, the regulation ought not to exist. If a particularly regulatory requirement is necessary, it ought to be in place and be enforced. The debate should be over whether the governmental agency or the self-regulatory agency can do it most effectively and most efficiently.

As I have said here today, I have one other thought on self-regulation that is not in my comments, but it occurs to me that I have never seen a study that pulled together and laid out, and analyzed, the sum of the SEC resources, all of the resources of the SEC, plus all of the self-regulatory organizations, their regulatory enforcement function and resources, and then said, now let us try to compare that to what we are trying to regulate.

It has been done on a piecemeal basis, looking perhaps just at the SEC, but I have never seen such a comprehensive study. It may be well worth pursuing.

On the question of general questions for improvement, those are laid out again in much more detail in my statement.

EDGAR

Let me run through them real quickly. First, EDGAR. Get it up and running. Get it up and running as soon as possible, debug it, do whatever is necessary. It is time for an electronic filing system. It has a lot of value as a surveillance tool, in addition to being a filing system.

General modernization of equipment at the SEC. This might sound like a nitpicking thing that I have focused on, but the SEC and the staff is over there working with word processing equipment that is 12 years old, light years behind the private sector. Many people on the staff, most of the staff don't even have dictation equipment supplied to them, yet they are doing battle with law firms that have optical character readers, high-speed laser printers and outnumber the staff in sheer numbers of people they

can throw at a project. There is much to be gained by a complete modernization, modernizing of the equipment that is there.

Comprehensive systems for regulating the securities markets. I essentially agree with what others have stated. Continued improvements with market surveillance.

Oversight—others have commented on that. I endorse it and refer to my written statement.

Federal-State law conflicts—something Milton Cohen touched on briefly. The proper roles and extent of State and Federal law in our regulatory system remains a major issue. It spills over in a lot of ways. Defensive tactics, targets, one share, one vote. And you can go on down the line.

I think a better, more consistent theme needs to be enunciated. It may well take Congress to do that.

Political crossfire—I will simply refer you to my urging that there be better long-term planning between the SEC and the Congress. I think it would make the entire system much more effective.

Staff and resources—I think, quite frankly, and by the way, many of the things that I have suggested ought to be done to improve the SEC, the SEC is, in fact, looking at attempting to deal with, and they can't do many of them by themselves.

BUDGET INCREASE

Resources—I am in agreement with everyone else today, that there needs to be a substantial increase. I would point out that the increase that has been requested, $30.5 million, while it represents a 27-percent increase in budget, increases the staff by only 14.3 percent, and in many instances, the increase in some of the divisions, Investment Management, the Office of Legal Counsel, Supervision of Markets, is very modest, even with the increase in budget and staff that is requested.

The SEC itself estimates that in 1988, it will review a smaller percentage of 10K's than it reviewed in 1987 or in 1986. In those 2 years, it was 16.9 and 17.1 percent. And those figures themselves represent a significant decline from a level of 21 percent reviewed in 1985.

I might offer my view that the 21-percent level itself is vastly inadequate. Furthermore, even with the increased budget, the SEC estimates it will bring fewer enforcement cases in in 1988 than it did in 1987 or in 1986. And if you look at figures over the past 10 years, you will see that, in raw numbers alone, the average number of enforcement cases has declined.

I have stated a number of times that I think a 25-percent immediate increase in budget in the staff is necessary; 50 to 75 percent at a minimum over the relatively short term, and I don't really quarrel with the doubling. I do think you have to have time to space it out and do it logically. I tried to do some very rough cut numbers in terms of what it would take to support a 25-percent staff increase, which would get the staff up to a little over 2,400. My number, which is calculated very simply by dividing the number of staffers requested for 1988 into the requested 1988 budget estimate to get a per employee figure. If you go up to 2,400

plus staffers, the necessary budget would be $170 million. That is substantially over what the SEC has requested. That per employee cost is just one way to get to a very rough estimate, I concede.

I think the SEC's estimate of 1988, which I have referred to, you can simply go through and look at the comments that are made there. They are the best evidence of the need for increase. A 10-percent increase in filings. They constantly talk about dramatic transformation, the growth of the securities industry, continued sharp growth in trading volume. An 1,100-percent increase in investment company shares being sold, anticipated continued high levels of enforcement activity, plus demands on the General Counsel's Office at the appeal side.

Just a couple more things on the need for resources. When the assessment is made, there is some soft information that I hope would be taken into account. I think Harvey, and perhaps Milton talked about the need to attract and retain the most highly qualified people. It has to be done. The salary differential is just too vast right now, not just the salaries at the beginning level. At the top end, the director of a division at the SEC, I believe, is paid about $70,000 unless the congressional pay hike will change that somewhat. It is tiny.

The current events and attitudes that have been demonstrated by the insider trading cases suggests a lack of disrespect and perhaps suggests a feeling, I can't quantify how widespread it is, that law enforcement may be spread too thin and people think they can get away with it.

The other thing that is a problem with budget is a pressure from the Office of Management and Budget to reduce the average GS rank. It is commented on in the 1984 and 1985 SEC reports, to the effect that the OMB had given directives to reduce the average rank. Yet you have an agency which is an agency of professionals, lawyers, accountants, primarily. Those are people who are going to be in the higher GS levels, and when you apply these across-the-board directives to any agency without regard to its particular characteristics, that agency suffers further.

To go back to 1972 to the Wells Committee, a private sector group recommended a doubling in the size of the staff in 5 years. In 1971, John Moss, chairman of the House Oversight Committee, asked Mr. Casey, then Chairman of the SEC, are you satisfied that the old Bureau of the Budget, more recently the OMB had approved adequate budgets? Mr. Casey, I don't believe they have. Back going over the years, I think the SEC didn't request adequate budgets. When it did request budget increases, too frequently their requests were reduced by the Budget Bureau and then too frequently were reduced by Congress. That was 1971 and 1972.

I have some comments about some additional remedies and sanctions. They are partly tied to the work that I have done with a private study commission over the last 2 years since I left the SEC. I would be delighted to answer questions. That commission, which is focusing on fraudulent financial reporting has recommended sanctions, including fining authority, cease and desist, more criminal prosecutions. We have some studies that we believe are fairly convincing in suggesting that the general public, and by that I mean

CEO's, CFO's, lawyers and accountants, do believe that sanctions are generally inadequate.

Finally, on the subject of the budget.

REMOVE SEC FROM THE BUDGET PROCESS

Again, you can read my comments. It occurs to me that the only realistic alternative to solving the budgetary process may be to make the SEC a financially self-sustaining agency, perhaps like the Comptroller of the Currency, and remove it from the regular budget process. That would allow the debate to be, first, over what the SEC needs to do, not about the budget. Later, the SEC can be self-supporting. It takes very little effort to adjust the fee scales to make it self-supporting in virtually any year.

I don't think this undermines the ability of the Congress to oversee the agency or that it makes it any less responsive. I would like to say that I offer that suggestion, which is a bit different from the one Harvey offered, on solving the salary problem specifically. Seriously, it's not a flippant suggestion and I'd be delighted to work with this committee or the SEC or any other committee to try to develop such a system.

Thank you.

[The complete prepared statement of James C. Treadway follows:]

3. Does the SEC currently have adequate resources to do its job correctly and adequate remedies to deter securities law violations?

There can be little doubt that the Commission lacks both the resources and the remedies that are necessary if the agency is to deter securities law violations in the most efficacious manner. Saddled by budgetary constraints and a six-year policy of enforced silence about those constraints, the Commission is in danger of falling behind in the effort to police our securities markets.

The young and talented lawyers graduating from law school these days, many of whom have assumed heavy debts to pay for their educations, must take what amounts to as much as a $40,000 pay cut if they opt for the privilege of working for the SEC. More and more frequently, the best law school graduates are instead choosing not to work for the government. Even those bright and dedicated professionals who are still attracted to the SEC cannot avoid being struck by the grossly higher rewards garnered by their contemporaries in the private sector; as a result, the SEC finds it increasingly difficult to retain its professional staff members after investing in their training and professional development. 30/

30/ In an effort to reduce lawyer turnover, the Commission requires a two or three year moral commitment from new hires, a commitment that I also imposed during my tenure as SEC General Counsel. The Commission staff has sometimes been driven to extreme lengths to enforce such commitments. The Legal Times reported several years ago that Kathryn B. McGrath, Director of the Commission's Division of Investment Management, had told an Investment Company Institute-sponsored conference that the industry should "keep your hands off" attorneys who had been at the agency for less than three years. The Legal Times quoted Ms. McGrath as saying,

> Don't hire my best people and then come complaining to me about delay, or ask for expedited treatment of a filing. If you do call, I can promise you my answer will be short and not-so-sweet,

Footnote Continued

While law firms, investment banking firms, and corporate general counsels' offices may benefit in the short run from this salary chasm, these disparities in pay could have profoundly adverse repercussions throughout the private sector. If the SEC fails to attract the talent that it requires, complicated private sector transactions could, increasingly, become bogged down in a morass of regulatory mediocrity and red tape, while the central issues may not be adequately addressed.

Section 4(b) of the 1934 Act, as enacted, expressly authorized the Commission to:

> fix the compensation of such officers, attorneys, examiners, and other experts as may be necessary for carrying out its functions under this Act, without regard to the provisions of other laws applicable to the employment and compensation of officers and employees of the United States, and * * * subject to the civil-service laws, appoint such other officers and employees as are necessary * * * 31/

This provision, which can be traced to the earliest drafts of the 1934 Act, manifests Congressional intent that the SEC not be subject to civil service constraints on the salaries

30/ Footnote Continued From Previous Page

> probably in words of four letters or less.

The Legal Times also reported that such public comments had been combined with private arm-twisting of staff attorneys and the firms that wanted to hire them. Legal Times, December 17, 1984, at 1.

31/ Act of June 6, 1934, ch. 404, § 4, 48 Stat. 881, 885 (emphasis supplied). Although this exception from civil service constraints was never repealed, subsequent legislation and executive action caused the SEC to fall under the civil service system, and the codification of § 4(b) deleted the emphasized language as "obsolete and superseded." See 15 U.S.C. § 78d note (1982).

paid to its professionals.32/ The earlier legislation establishing the Board of Governors of the Federal Reserve System (the "Board") contained similar language.33/ These provisions indicate Congressional concern that the agencies have sufficient flexibility to hire the very best applicants. In both cases, the failure to attract top talent can have a devastating impact on the national economy and financial system that far outweighs the compensation cost in question. Nevertheless, while the Board has had the benefit of flexibility in this area,34/ the Commission continues to be bound by the restrictive salary scales of the civil service system.

For those bright, young professionals who choose to start their careers at the SEC, despite salary disparities, there is growing resentment about the substandard professional conditions that prevail in one of the country's most important agencies. Walking through the halls of 450 Fifth Street, overcrowding is readily apparent with the doubling up of professionals in offices too small to house even a single lawyer. Additionally, there is a distressing lack of critical paraprofessional and secretarial assistance, and an absence of even the most rudimentary facilities, supplies and amenities a government agency needs in order to function effectively, such as file storage space and conference rooms.

The Commission's recent absorption of its Washington Regional Office has only exacerbated these problems. And, I am concerned that the Commission will not focus this Subcommittee on the plain truth -- that even the modest proposals which the

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32/ See, e.g., H.R.7852, 73d Cong., 2d Sess. § 30, introduced by Representative Rayburn on Feb. 10, 1934; S. Rep. No. 792, Federal Securities Exchange Act of 1934, 73d Cong., 2d Sess. 15 (1934) ("[the subsection] authorizes the Commission to appoint and fix the compensation of such employees as may be necessary for performing its functions under the act without regard to civil-service laws.").

33/ See § 11(l) of the Federal Reserve Act of 1913, 38 Stat. 251, 262, codified as amended at 12 U.S.C. § 248(l) (1982).

34/ See, e.g., In the Matter of Federal Reserve Board - Applicability of Senior Executive Service, 58 Comp. Gen. 687 (July 30, 1979).

Commission is belatedly embracing for personnel expansion will place even more severe strains on the agency's already overtaxed physical plant. I encourage the members of this Subcommittee to take an unannounced trip to the SEC, to view first hand the conditions to which I am referring.

I recognize that, in this era of Gramm-Rudman, there is bound to be a considerable degree of concern over proposals to increase the SEC's budget and the salaries of its employees, particularly since the senior Commission officials earn slightly more than $70,000 per annum, a figure that the vast majority of American wage earners would find attractive. But, the facts are that the Commission's resources are meager by any fair standard of comparison, and the agency's mission is of vital national importance.

I believe the political and public concerns about increasing the size of the agency's budget and the take-home pay of its employees can be allayed by a simple expedient -- placing the Commission on a self-sustaining basis, and relieving the Commission of the constraints that presently limit the salary scale to Civil Service-prescribed amounts. As I have indicated, this is not a novel proposal: it has its antecedents in the original legislation creating the SEC, and it would put the Commission on a par with the Board of Governors of the Federal Reserve System in terms of salary scale.

The Commission's belated recognition of its personnel limitations is encouraging, but brings to mind the aphorism of "too little, too late." The Commission's proposals would not serve to alleviate backlogs and deficiencies in a whole host of Commission programs, including the Commission's enforcement program, which apparently would be the chief beneficiary of the current budget proposals.

Finally, the question of the adequacy of the Commission's remedies is a perplexing one. The agency struggles, year after year with the same limitations with which it has been encumbered for many years. One reason for the agency's reluctance to request additional authority is its concern about the legislative process. In this regard, the agency has been joined by a willing ally -- the private sector -- which fears the creation of too many novel powers in an agency that has shown itself capable of very hard-nosed law enforcement. It is time that the Commission be granted access to a broad range of cease and desist powers and other remedies to permit it to tailor its actions to the circumstances at hand.

Legislative Recommendations

In response to the problems that I have described, I believe that the Subcommittee should consider the following specific legislative initiatives:

1. The Commission's budgetary and manpower constraints should be alleviated by permitting the agency to fund its operations from the private sector, and to pay its employees a competitive salary, above the current Civil-Service scale. Filing and other fees, and perhaps even penalties under the Insider Trading Sanctions Act (assuming that conflict-of-interest concerns can be overcome), should be utilized to fund the Commission's operations.

2. Concomitantly, the Commission should be given the power to negotiate its own lease, free of the constraints imposed by budget limitations and the General Services Administration.

3. The Commission's rulemaking authority should be expanded, to enable the agency to cope with changing investment products -- such as financial futures -- and changing securities services -- such as the provision of discount brokerage services by depositary institutions.

4. The substantive law applicable to insider trading should be overhauled, to remove uncertainty, clarify the misappropriation theory, and define the concept of insiders.

5. The current legislation regarding tender offers and related corporate transactions should be overhauled to eliminate obvious abuses and to conform the legislative scheme to the realities of today's markets and technologies.

6. The Commission should be given cease-and-desist powers to enable the agency to deal with abusive conduct affecting the entire gamut of the securities laws.

7. The Commission's traditional injunctive authority should be clarified to confirm the SEC's authority to seek a host of equitable remedies, such as the disgorgement of ill-gotten gains, the appointment of receivers, and the requirement that institutional violators of the federal securities laws be directed to implement prophylactic measures to ensure against a repetition of the violative conduct.

8. The Commission's disciplinary authority over broker-dealers should be clarified, so that there will be no dispute concerning the agency's power to suspend errant professionals for a period exceeding twelve months but less than a lifetime bar.

9. Legislation should be enacted to encourage foreign governments to enter into formal cooperative ventures with U.S. law enforcement authorities, similar to the memoranda of understanding between the United Kingdom and the United States and between Switzerland and the United States, to ensure mutual evidentiary assistance in cases of national importance.

10. Legislation should be enacted to authorize the SEC to require firms and professionals who are privy to market-sensitive, nonpublic information to adopt meaningful guidelines, much as section 17(j) of the Investment Company Act of 1940 requires portfolio managers of investment companies to adhere to standards adopted by their own firms.

Finally, Congress should authorize a broad-based study of the securities markets to determine whether additional legislative initiatives should be pursued. Under the direction of the relevant Congressional Committees, the study group should include Congressional staff, SEC personnel, and private sector representatives.

It has been an honor to appear before this Subcommittee today, and I appreciate the opportunity to express my views on these important issues.

STATEMENT OF

JAMES C. TREADWAY, JR.

Before the
Subcommittee on Securities
of the
Senate Committee on Banking,
Housing and Urban Affairs

February 24, 1987

Mr. Chairman and Members of the Subcommittee:

My name is James C. Treadway, Jr., and I thank you for inviting me to appear before this Subcommittee. I am a partner in the Washington, D.C. office of the law firm of Baker & Botts. I have engaged in the practice of securities law for more than 20 years, including serving as a member of the Securities and Exchange Commission from 1982 to 1985. Since I left the SEC, I also have served as the Chairman of the National Commission on Fraudulent Financial Reporting, a private sector study commission inquiring into the causes, detection and prevention of fraudulent financial reporting. That Commission is scheduled to release an exposure draft of its report in April, 1987 and to conclude its work by early Fall, 1987.

Notwithstanding my various affiliations, the views expressed today are solely my personal views. They should not be attributed to any other individual or to group.

The Subcommittee's invitation to testify asked that I comment on:

- the respective roles of the government and the private sector or self-regulatory organizations in regulating the securities markets;
- possible changes in the SEC's activities and possible improvements in the regulation of the securities markets; and
- the adequacy of SEC resources to fulfill its statutory mandates and the adequacy of remedies to deter violations of the securities laws.

I. Governmental Regulation and Self-Regulation.

Our system of shared or cooperative regulation between the government and industry self-regulatory organizations, such as the National Association of Securities Dealers, Inc. and the various securities exchanges, is sound, has withstood the test of time, and ought not to be abandoned. Self-regulation as a major component of our overall regulatory structure is so ingrained in our system of securities regulation that reversing fifty-three years of history and transferring to the government all the functions of the SROs is neither wise nor workable. If anything, such a restructuring of our regulatory system could lessen the effectiveness of regulation. Furthermore, such an undoing of history would create a mammoth governmental regulator far beyond any demonstrated legitimate needs.

The SROs play a substantial and desirable role in regulating the securities industry and protecting investors. Some regulatory functions, such as regulating trading activities on floors of the exchanges and in other trading systems, are performed more effectively and efficiently than might be the case if the SEC attempted to perform those roles directly. As a practical matter, self-regulatory agencies can more effectively garner the resources necessary for comprehensive inspection programs of broker-dealers and investment advisers. The market oversight and surveillance function performed by the SROs is more sophisticated and more effective than would be the case if the SEC attempted to perform this function alone. Furthermore, the SROs can perform functions beyond those the SEC has the statutory power to perform. For example, the SROs can promote ethical standards of conduct which go beyond legal requirements the SEC can impose.

Notwithstanding my strong support for our existing system of shared regulation, self-regulation is subject to various limitations and impediments, which ought to be noted.

1. Self-regulatory organizations are controlled by industry members who are themselves the subjects of regulation. Self-regulatory organizations thus naturally find it easier to take steps to combat and curb fringe or marginal elements of an industry whose practices are recognized as beyond the border of a acceptability by the mainstream members of the industry. At the same time, it is more difficult for the industry to develop and enforce standards that may require modification or elimination of practices engaged in by even a mainstream minority within the industry. The more prevalent the practice is, the more difficult it is for an SRO to challenge that practice

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2. Unlike government authorities, self-regulatory organizations lack subpoena power. They cannot compel testimony or collect evidence from the general public. The SROs investigative and disciplinary powers allow them to gather available evidence only from member organizations and their employees. Many cases-- particularly those cases involving a dispute between the firm and its public customers, -- simply cannot be effectively investigated or prosecuted within these limitations if the customer chooses not to cooperate fully. The lack of compulsory process thus can be a significant impediment. Furthermore, walking the line between the customer and the firm can be a tricky and awkward process. By contrast, based on any experience as a Commissioner, SRO actions involving the financial responsibilities of a firm seem to be naturally easier for an SRO to institute. In those situations, the financial instability of one firm can endanger a number of other firms, even the SRO itself. The SROs have an added impetus to move rapidly against those who violate the SRO's financial responsibility requirements in order to protect the financial health of its other member firms.

3. Disciplinary decisions of self-regulatory organizations are based on a businessman's standard and sense of fairness. Arguably, this standard is less precise than legal standards, generating a potential for inconsistency among these decisions. This inconsistency increases the potential that the losing party will appeal to the government, layering the governmental process on top of the self-regulatory process.

4. All self-regulatory organizations have a potential for activity which is either anti-competitive or contrary to the public interest. For example, we ought not to forget that self-regulation, in years past, gave us fixed commissions, restrictions on corporate and foreign membership on exchanges (which deprived firms of much needed permanent capital), a host of uneconomic, baroque commission-splitting practices, and the back-office debacle of the later 1910's and early 1970's. Thus, giving authority to self-regulatory agencies that goes beyond regulation of trading and those other activities they can conduct more effectively than the SEC carries at least a potential for undesirable results.

5. Reliance on SROs does not mean that it is any easier to fund the regulatory function. The SEC, of course, is subject to the budget processes of the federal government, with all the imperfections, frustrations and delays that entails. That budgetary process frequently prompts some to suggest that delegating more and more SEC functions to the SROs is desirable, economically expedient, and would lessen the budgetary pressures on the SEC. And the SEC in the past has candidly admittedly that its financial and staff resources have caused it to delegate functions to the SROs or to "lean

on" them to assume greater responsibility. But the SROs themselves are subject to budgetary pressures. In the long run, the SROs must impose fees upon and collect revenues from their members and regulatees. Unless the SROs can justify these charges, they run the risk of losing the support of their members/regulatees. Thus, the SROs operate subject to their own set of budgetary pressures, just as the governmental budget process presents a problem to the SEC.

6. Increased reliance on SROs does not necessarily reduce the need for SEC staff and resources. As SROs assume more responsibility and expand their activities, the SEC must assign more personnel to oversee the SROs, a substantive activity. Furthermore, the SEC sits as an appellate body, hearing appeals from SRO disciplinary proceedings. Thus, the SEC is not isolated from the self-regulatory process, but is an integral part of the process.

7. Self-regulation, some charge, may actually be more costly than direct government regulation and actually constitute a means for disguising or burying the true costs of governmental programs, such as securities regulation.

8. The SROs are businesses themselves. They develop products, design trading systems and linkages, and compete with one another in numerous ways. The multiple activities they perform provide some potential for conflict between their "business" activities and their regulatory function. Careful monitoring is necessary to assume the correct balance of activities.

To conclude on self-regulation, I endorse the basis system-- it works, and it works well. Indeed, the SROs have frequently been ahead of the government. For example, the NYSE market surveillance system is substantially more sophisticated than the SEC's MOSS, and the SROs have taken the lead in developing pieces of a national market system. Furthermore, the SROs (New York Stock Exchange and National Association of Securities Dealers) performed over 5,000 broker-dealer inspections in 1986, an invaluable supplement to the SEC's efforts. It is simply difficult to envision the SEC's being able to assume direct responsibility for that activity. I also would add that, based on my experience as an SEC Commissioner, that the degree of tension between the SEC and the SROs is about at the right level. The SEC sometimes pushes the SROs; and the SROs sometimes prompt the SEC to move.

I offer one final thought. Some who praise self-regulation may do so because they believe the SRO will have a lighter regulatory hand. But any debate about self-regulation vs. government regulation ought not to be a disguised debate about the level of regulation. If the particular regulation is too extreme, the regulation should

be eliminated. If the particular regulatory requirement is needed, it should be unhesistatingly imposed. In evaluating self-regulation, the question to be asked is not whether an SRO, in performing the regulatory function, will be more light-handed. The debate should be over which body -- SRO or government -- will performed a designated regulatory function more efficiently and effectively.

II. Possible Improvements In The Securities Markets and Securities Regulation.

The Subcommittee's letter also asked that I comment on possible additional SEC activities and possible improvements in the regulation of the securities markets. Part III of my statement addresses the need for additional resources and remedies.

In addition, I would identify the following as areas which require improvement or resolution. Some of these areas already are on the SEC's agenda, and I urge the SEC to move briskly and the Congress to support the SEC in resolving these issues. I also note that many of these open issues are beyond the ability of the SEC to resolve alone. Some require the involvement of other U.S. authorities, and some require the involvement of foreign agencies and authorities.

EDGAR. First, all necessary steps should be taken to move EDGAR to a fully operational level, and as soon as possible. Whatever needs to be done to debug EDGAR, to reconfigure it, to resolve any open legal issues, or to resolve any operational issues ought to be done quickly. Aside from dealing with the paper glut and recognizing the reality of electronic communications, an electronic filing system has vast potential for enhancing the extent and quality of surveillance, oversight and monitoring of the securities markets.

General Modernizing of Equipment. In addition to EDGAR, the SEC needs to update and modernize other equipment, principally its word processing capability. The various divisions and offices essentially are large and accounting law firms. They investigate, conduct legal research, interpret rules and regulations, write legal memoranda, prepare legal pleadings and briefs, research formal opinions, and issue opinions. Much of the work of these divisions involves a written product. Yet, in the key area of word processing, the SEC is stuck with antiquated equipment and is missing many opportunities for efficiencies and productivity increases. The SEC's automated word processing equipment is 12 years old -- light years in terms of current technology -- and even that equipment is scattered through the agency on a limited basis. Furthermore, basic dictation equipment is provided to only a few staffers. This combination results

in the frequent handwritten production of documents and reliance on basic electric typewriters for many documents. Along with EDGAR and the move into the 20th century of electronic filing, similar improvements in word processing equipment are absolutely essential.

Comprehensive System For Regulating The International Securities Markets. Global securities markets are here; the technology which makes global markets possible already has outstripped regulation; and international securities law violators are becoming more sophisticated every day. The issues are vast, and the obstacles to a coherent, comprehensive, fair and efficient system of global securities regulation are mammoth. Merely listing the issues and difficulties is almost overwhelming: inconsistent disclosure and accounting standards from country to country, foreign secrecy and blocking laws, the efficient settlement of cross-border trades, twenty-four hour trading, the proliferation of financial products, and historic differences among countries in business customs and legal traditions.

Continued Improvements in Market Surveillance and Oversight. Past efforts to install and improve market surveillance and oversight systems to detect manipulation, market-rigging, insider trading and other abuses which undermine public confidence in the fairness of our markets must continue and increase. Efforts to date have been, I believe, commendable, but they must be enhanced.

The Federal-State Law Conflict. The proper roles of state law and federal law in our securities regulatory system remains a major issue. The issue manifests itself in many ways -- one share, one vote; tender offer regulation generally; defensive tactics of target companies in hostile takeovers; and so on. Those are difficult issues, and the extent to which federal law -- directly or indirectly -- can and should override state law remains an issue the SEC resolves sometimes inconsistently. Sometimes the SEC moves to override state law; sometimes it does not; and positions can flip-flop as Commissioners come and go. A more logical and coherent overall theme -- perhaps enunciated by Congress -- would enhance the effectiveness of the SEC, if only by defining the limits of federal and state jurisdiction.

The Political Crossfire. The next item on my "to do" list may be a practical impossibility. It certainly is beyond the power of the SEC, alone, to achieve; and perhaps it contains elements of high philosophizing. Former and highly respected SEC Chairman William Cary once observed that the SEC, while an "independent" agency, needed the support of both Congress and the Executive Department to be effective. He also observed that an agency at odds with either was foreordained to be ineffectual. Enhancing the degree of cooperation between Congress and the SEC deserves

attention by all. I am not suggesting that Congress not be vigilant in overseeing the SEC, nor am I suggesting that the SEC and its Commissioners should be anything other than independent. I also recognize that an independent agency and the Congressional oversight function invariably introduces a certain tension into the atmosphere. Nonetheless, agreement on long-term goals and the absence of a hostile atmosphere are essential to the best functioning of the agency. I have no specific roadmap to offer to achieve this state of mutual support, but I urge that this objective be placed on the agenda of all.

III. Adequacy of Staff Resources and Remedies.

When I left the SEC in the Spring of 1985, I publicly stated that I left with nothing but respect and affection for the agency, as an institution, and for the staff and the members of the Commission. I reiterate those views today, and nothing I say today should be interpreted to the contrary. I also praise the Commission and staff for efforts to increase efficiency and productivity. Such efforts are admirable, and ought not to be the subject of unfair criticism. My comments, nonetheless, will suggest a need for greater SEC resources.

Resources Generally

I applaud the SEC's recent request [illegible] increased budget for 1988. The only problem is that the requested increase is not enough. The $30.5 million increase requested represents almost a 27% increase in the budget, but it allows an increase in staff of only 14.3%, from 1,950 in 1987 to 2,086 in 1988. Even with the requested increase, in 1988 the staff of the SEC will be larger by only 77 people than it was in 1978 (2,086 v. 2,009). */ That represents a total increase of 3.8% in ten years -- a decade which has seen an explosion in the demands on the SEC and in the securities markets.

At the same time, to focus momentarily on just a few statistics, even with the increase in budget and staff the SEC estimates that it will

- review a smaller percentage of Form 10-Ks -- the key to the integrated disclosure system -- in 1988 (16.7%) than in 1987 (16.9%) or in 1986 (17.1%), and each of those years represents a significant decline from 21% reviewed in 1985; and
- bring fewer enforcement cases in 1988 (300) or in 1987 (280) than in 1986 (313).

While SEC activity and levels of review of certain types of filings increase minutely, in 1988 in no instance does the level increase significantly.

On numerous occasions I have expressed my view that a 25% short-term increase in SEC staff is desirable. I expressed that view while at the Commission and upon leaving the SEC. Nothing I have seen since I left the SEC causes me to change that view. In terms of increases over the long term, I believe that an increase of 50-75% is necessary, and I do not seriously quarrel with those who support a doubling of staff over a five year period. */ At the same time as I voice support for the foregoing, specific increases, it is only fair to acknowledge that there probably is no single number of staff or dollar resources that is precisely correct. The budget and estimating process is not a science, and land as we may try to make it totally precise.

My rough calculatioms suggest that a 25% staff increase, to 2,438, would require a 1988 budget of approximately $170 million. That would represent a 48.5% increase from the 1987 budget of $114,500,000. My calculation is based upon an average per-employee cost reflected in the 1988 Budget Estimate of $69,528, multiplied by 2,438 staffers.

Information from the 1988 Budget Estimate

The explosive growth in the securities market and in the Commission's responsibilities has been well documented by any number of sources. The stresses to which the SEC is being subjected because of the explosion in the marketplace and the expansion of securities regulation is evidenced by the SEC's own document -- its 1988 Budget Estimate. Regardless of the program involved -- full disclosure, enforcement, market regulation, or any other program -- the stresses to which the SEC is subject are painfully portrayed.

*/ The various statistics contained herein have been culled from recent SEC Budget Estimates (1980-88) and SEC Annual Reports (1974-85).

*/ My hesitation in endorsing such a doubling of staff is the need to absorb staff efficiently, to plan for this increase, to locate physical facilities to accomodate a larger staff, and the need to support them with modern office technology equipment in all respects.

Corporation Finance

Consider a few statements from the 1988 Budget Estimate discussion of the SEC's full disclosure program:

"The program [Full Disclosure] operates in a securities market where, in calendar 1985, the total value of securities registered under the 1933 Act exceeded $350 billion, and where almost $1.4 trillion of equity securities were traded on exchanges and the National Association of Securities Dealers' Automated Quotations System (NASDAQ).

. . .

"The level of registered equity and debt financing is expected to keep 1933 Act IPO and repeat registration statement filings, including Form S-18s filed in the regional offices, at high levels through 1988." (Emphasis added.)

. . .

"The program's rulemaking activity will continue at approximately the 1986 level. Substantial rulemaking activity is anticipated in modernizing the capital raising process to conform to securities markets developments. The implementation of EDGAR will require extensive revisions to existing rules which were designed to accommodate paper and the addition of new rules to take advantage of the benefits of electronic filing and review. In addition, the internationalization of the securities markets will require review of the regulations applicable to foreign capital markets and rulemaking efforts to accommodate cross border and global offerings and trading. Rulemaking efforts will proceed in the areas of proxy solicitation, takeovers and contests for corporate control, entailing extensive review of existing filing, dissemination, disclosure and other regulatory requirements." (Emphasis added.)

. . .

"In the accounting policy area, the staff expects a high level of private sector standard-setting activity, as well as a substantial number of peer reviews, both of which will necessitate SEC oversight. Moreover, the Commission will continue to devote substantial staff accounting resources to resolution of complex accounting issues, reviews of filings and enforcement investigations involving auditing and financial reporting." (Emphasis added.)

"By 1988, the staff expects the total number of disclosure filings received by the document receipt and distribution staff to increase 10% over 1986 levels. Over the 1986-1988 period, the Commission's Office of Consumer Affairs and Information Services projects a 15% increase in

FOIA and confidential treatment requests and a 10% rise in the number of telephone inquiries." (Emphasis added.)

The 1988 Budget Estimate also shows that, notwithstanding the requested increase in staff and resources, the level of activity in certain key areas involving full disclosure will decline or remain static.

	1986	1987	1988 (Est)
1st time registration statements reviewed	883 (72%)	883 (71%)	883 (73.5%)
Annual Proxy Statements reviewed	1,629 (19.5%)	1,419 (16.7%)	
Annual Reports (Form 10Ks) reviewed	1,741 (17.1%)	1,741 (16.9%)	1,741 (16.7%)

A particular striking figure from the above chart is the low number of annual reports reviewed. The Form 10-K is the absolute heart of the integrated disclosure system. Yet, the percentage of Form 10-Ks reviewed or to be reviewed, as shown above, actually represents a significant decline from the 1985 level. That year the SEC reviewed 2,064 annual reports out of 9,847 filed, a total of 21%. My personal view is that even a 21% level of review is far from adequate, given the significance of the Form 10-K to our disclosure system.

Enforcement

Similar indication of pressures on the SEC to do more and more appear in the 1988 Budget Estimate's discussion of the enforcement program.

"The securities marketplace is undergoing a dramatic transformation. With market growth, mergers within the financial services industry, and the advent of global securities markets, the Commission's enforcement program is being confronted by greater demands." (Emphasis added.)

"This growth [in the securities industry] has been accompanied by a significant increase in the number of market participants subject to Commission regulation. Effective broker-dealer registration rose to 11,688 by the end of fiscal 1986, an increase of 87% from 1982. During the same period, the number of registered investment advisers grew 179% to 11,700, and the number of investment companies rose 85% to 2,458. Industry growth has also been accompanied by increases in the indices of potential fraud. For example, since 1982, complaints received by the NASD (National Association of Securities Dealers) have increased 118% to 3,414 annually. Moreover, as complex financial instruments

proliferate and markets cross international boundaries, the pursuit and deterrence of fraud becomes increasingly difficult." (Emphasis added.)

. . .

"The Commission continued to assign high priority to fraud by reporting companies, and to focus greater attention on the adequacy of corporate financial information in registration statements and periodic reports. ... These cases are often complex and require more resources than other types of cases." (Emphasis added.)

"The largest number of enforcement cases involved regulated entities such as broker-dealers, investment advisers and investment companies. As the securities markets grow and more individuals come in contact with the financial services industry, it is increasingly important to ensure the integrity and fairness of the entities that participate in the industry." (Emphasis added.)

. . .

"Cooperation with assistance to the Department of Justice, state and local authorities, and self-regulatory organizations in law enforcement efforts became increasingly important. During 1986, an estimated 26,426 staff hours were committed to assisting other law enforcement agencies with criminal prosecutions, almost 8% more than in 1985."

These general comments about demands on the enforcement function need to be coupled with some historical statistics. The Commission's statistics show a 41 percent increase in enforcement actions from 1981-85, a result that deserves praise. Yet, even with those increases, the Commission's enforcement activities over recent years indicate a decline, when measured solely by the number of cases brought.

In 1985 and 1986, respectively, the Commission instituted a total of 260 and 313 injunctive actions and administrative enforcement proceedings. By contrast, in the five years from 1974-78 the Commission instituted a total of 1,471 such actions and proceedings, or an average of 294 actions per year. In the last five years (1982-86), the Commission instituted 1,353 actions, an average of 271 per year. Furthermore, even with the requested increases in staff and dollars, the SEC estimates that the number of enforcement cases in 1987 and 1988 actually will decline, from 313 in 1986 to 280 in 1987 and to 300 in 1988.

Given, over recent years, a 700 percent increase in equity securities trading volume, a 400 percent increase in securities salesmen, a more than 200 percent increase in registered broker-dealers and investment companies, a more

than 300 percent increase in registered investment advisers, as well as increases in many other sectors of Commission activity, one must ask whether the SEC's level of enforcement activity -- measured by raw numbers -- has kept pace with developments in and the expansion of the markets. */

The following chart reflects the Commission's enforcement activities in recent years:

1974 - 88

	Injunctive Actions Instituted	Administrative Proceedings Instituted	Total
1988	165	135	300
1987	155	125	280
1986	177	136	313
1985	143	117	260
1984	179	114	293
1983	151	94	245
1982	136	106	242
1981	114	72	186
1980	103	74	177
1979	108	81	190
1978	135	122	257
1977	166	142	308
1976	158	129	287
1975	174	132	306
1974	148	165	313

*/ I also note that the Commission has reported that it received more than 31,000 investor comoplaints during fiscal 1985. This volume of complaints, despite rising market prices, is more than triple the number of investor complaints reported by the Commission in 1975.

Market Regulation

In the area of supervision and regulation of securities markets, the 1988 Budget Estimate observes:

"The program workload is increasing due to continued sharp growth in trading volume and the number of registered broker-dealers, the proliferation of new and more complex financial products, the globalization of the trading markets, and 1986 legislation providing for the regulation of government securities brokers and dealers." ("Emphasis added.)

. . .

"Market activity and complexity have increased during recent years. For example, trading volume in all U.S. securities markets has climbed sharply. Since 1980, annual exchange option turnover has grown from 96.8 million contracts to 232 million, and over-the-counter share volume in securities quoted on the National Association of Securities Dealers' automated quotations system (NASDAQ) increased from 6.7 billion to 20.7 billion. At the end of October 1986, exchange volume was over 30% ahead of its 1985 pace, options 35%, and NASDAQ 45%." (Emphasis added.)

. . .

"During the 1980's, the size of the regulated population has also grown significantly. The number of registered broker-dealers, 11,688 at the end of fiscal 1986, increased by 40% in the last four years alone. These firms have over 16,500 branch offices (representing a 124% increase over 1980) and 404,000 registered representatives (a 102% increase). The scope of the SEC's regulatory concerns has also broadened, because many financial institutions, such as banks and savings and loan associations and their affiliates, have recently extended the range of their securities activities. For example, in fiscal 1986, an additional 220 such firms registered with the SEC as broker-dealers or received temporary exemptions pending registration. Moreover, in the 1986 amendments to the Exchange Act, Congress gave the Commission added oversight responsibilities for government securities dealers. As a result of this new legislation, between 100 and 200 government securities broker-dealers and about three clearing agencies will be registering with the Commission for the first time." (Emphasis added.)

"Markets for new and more complex products are rapidly emerging. In the past three years, exchange trading was initiated for options contracts on a variety of debt instruments, market indexes, and foreign currencies. Trading in options on stock indexes already accounts for over 50% of all options contracts volume." (Emphasis added.)

"Increased pressures on program resources have also emanated from the need to keep abreast of market developments associated with the wave of corporate mergers and takeovers of the past several years. Significant staff time has been spent, for example, on advising on the assessing applicable trading practices regulations dealing with tender offers and in maintaining close liaison with the enforcement staff in its efforts to curtail such major abuses as insider trading." (Emphasis added.)

Investment Companies and Advisers

In the are of investment management regulation, the Budget Estimate states:

"The program workload is rising due to the dramatic growth in the number of registered IC's and IA's and the increasing diversity of financial products and complexity of utility holding company transactions." (Emphasis added.)

. . .

"Today, there are IC's registered under the Investment Company Act representing approximately 10,000 individual portfolios. To reduce burdens and costs to the industry, the staff has permitted IC's to combine several separate portfolios or investment series under one 1940 Act registration. Some Unit Investment Trusts ("UIT'S"), for example, have more than 500 separate series registered under one 1940 Act registration. Since the program must oversee each portfolio, the workload is effectively equivalent to a registered population of 10,000."

. . .

"Since early 1982 the number of IC's registered under the Investment Company Act has increased by 85%. However, there has been an even more rapid growth in IC assets. From 1982 to the beginning of 1987, those assets increased 202%, from $265 billion to $800 billion. Part of this increase is the result of rising stock and bond prices, but most of the growth reflects new sales of shares. During the same period, annual new sales of IC's (excluding money funds) grew from $16 billion to a record $194 billion, an increase of 1,112%." (Emphasis added.)

. . .

"The persistent rapid growth in the amount of assets held by IC's means that the IC industry has become one of the nation's major financial intermediaries, along with banks, savings and loan associations and insurance companies.... Because investments in IC's are not government-insured, investors rely on the Commission's

disclosure, regulatory and inspection staff to protect their interests."

. . .

IA's, including financial planners, are another major portion of the financial services industry in which there has been very rapid growth in both the number of registrants and the assets managed. At the beginning of 1982, there were 4,200 active IA's; at the beginning of 1987, there were 9,000, more than half of whom call their services "financial planning." ... Providing an adequate level of protection has become increasingly difficult as the number of registrants has grown." (Emphasis added.)

General Counsel - Legal Services

In discussing demands on the General Counsel's Office, the 1988 Budget Estimate continues the same theme:

"The Office of the General Counsel expects litigation volume to remain high in 1987. For example, as a result of enforcement recommendations, the number of disciplinary proceedings against attorneys and accountants is increasing. Similarly, the increased emphasis on insider trading actions in the enforcement program should produce a concomitant increase in the litigation handled by the Office of the General Counsel. The number of cases raising questions of international jurisdiction and discovery will increase. Two other areas where the volume of litigation likely will increase are suits against the Commission and suits to enjoin investigations." (Emphasis added.)

. . .

"It is anticipated that high levels of SEC enforcement activity will continue to generate a substantial caseload for the Legal Services Program. With the increased focus by the Division of Enforcement on financial fraud, the Commission has greatly increased the number of Rule 2(e) proceedings against accountants. Because these proceedings, which are litigated by the Office of the General Counsel, involve complex issues, intensive fact development, and the presentation of expert testimony, they require a substantial effort on the part of the staff." (Emphasis added.)

. . .

"Legislative proposals that would affect the Commission's work, such as the recommendations of the Vice President's Task Group on Regulation of Financial Services, banking and tender offer legislation, the recently-enacted government securities legislation, and Congressional investigation into the internationalization of the securities markets, generate a heavy workload for legislative and

advisory services activities. Other legislative proposals affecting workload are proposals to directly regulate the accounting profession and amendments to the Racketeer Influenced and Corrupt Organizations Act and Foreign Corrupt Practices Act. Commission testimony and legislative comments are prepared in response to Congressional requests for information concerning the impact of possible changes in the law on the Commission's activity. The advisory services provided to the Commissioners bring a broader perspective and greater consistency to enforcement and regulatory decisions." (Emphasis added.)

Historical Staff Size

Balanced against the demands on the SEC, highlighted in the 1988 Budget Estimate, the following chart shows the size of the SEC staff over recent years:

Year	Staff	
1988 (requested)	2086	
1987 (estimated)	1950	
1986	1898	
1985	1940	(1914 permanent)
1984	1895	(1863 permanent)
1983	1921	
1982	1886	
1981	1982	
1980	2041	(2009 permanent)
1979	2020	
1978	2009	
1977	1955	
1976	1922	
1975	1951	
1974	1814	
1973	1556	
1972	1559	
. . .		
1941	1711	

An increase in SEC staff from 2,009 in 1978 to 2,086 in 1988 would represent a total increase of 3.8% over a decade. A staff of 2,086 in 1988 versus a staff of 1,711 in 1941 represents an average annual increase of less than .5%.

The staff and members of the Commission -- past and present -- deserve praise for their effectiveness, efficiency, and dedication. Their accomplishments, despite limited resources, have been impressive, if not astounding.

Their efforts to enhance productivity are laudatory. But workload increases of 75 to 1,000 percent in areas of SEC regulation during the past decade simply cry out for substantial increases in staff.

Other Significant Factors

In addition to the dramatic increases over the past decade in all manner of activities regulated by the SEC, raw numerical increases alone do not tell the whole tale. They do not reflect the many subtle pressures and demands that quietly consume staff and other resources. Many of these pressures are government-wide, and perhaps cannot be dealt with on an agency-by-agency basis. Nonetheless, they should be taken into account in assessing the adequacy of the SEC's budget, for they are real.

First, the SEC needs to continue to attract and retain the most highly qualified individuals. The SEC's ability to do so is partly a matter of economics -- the ability to compete with the private sector. Yet, the real income of government employees reportedly has declined by 40% over the last decade, despite absolute increases in salaries. The salary of an entry level attorney at the SEC is approximately $25,000. Private law firms compete for the same pool of highly qualified individuals, offering starting salaries of $50-$65,000, plus signing bonuses of as much as $20,000.

A starting salary differential of a few thousand dollars is one matter and historically has not affected the ability of the SEC to compete for qualified professionals, but that situation no longer exists. At the other end of the scale, the problem is similarly acute. The Director of a division at the SEC is paid approximately $70,0000. That is only slightly more than starting attorneys in many law firms, perhaps even less than in some. These economic discrepancies contribute to high levels of staff turnover, which is itself a cost to the agency, a consumer of resources, and a source of inefficiency.

We also ought to keep in mind the resources of those in the private sector with whom the SEC's staff must litigate and negotiate. Even with the increases in staff requested, the attorneys the Division of Enforcement can commit to one major case, for an extended time, is far fewer than the number of attorneys any number of private law firms can devote to litigation with the SEC. One private law firm may easily commit thirty to fifty attorneys to an SEC matter, with clients more than willing to bear the expense. And frequently more than one major law firm may represent the same client. If the SEC were to devote even twenty or twenty-five attorneys full-time to one case for an extended

period of time, the Enforcement Division would be severely disrupted.

Current events and attitudes also need to be factored into the discussion about SEC resources. Recent accounts of blatant insider trading are well-known. Most media accounts suggest that more -- perhaps many more -- cases are to come. As disturbing as anything about these cases is the degree of brazenness and apparent total disregard for the law demonstrated. Those charged were not operating in a gray area of the law; to the contrary, the law was quite clear. Yet, they blatantly disregarded the law.

Why were they so unafraid? Did they believe they were above the law? Did they believe the SEC and the SROs lacked the detection and surveillance tools and staff to reach them? Perhaps no one has the answers to those questions, but these cases leave gnawing doubts. Is lawlessness widespread? Are the SEC -- and law enforcement generally -- spread too thin and simply not to be feared?

Another factor which can mask the true extent of staff resources necessary to accomplish the statutory mandate of the SEC is a persistent pressure from the Office of Management and Budget to reduce the average GS rank of SEC employees. For example, the 1974 and 1975 SEC Annual Reports refer to OMB directives that federal agencies reduce staff at the GS 11-15 levels. Efforts to control "grade creep" are, I suppose, admirable. But the SEC is an agency of professionals -- lawyers and accountants. The SEC's key resources are its professionals. When the SEC is subjected to across-the-board directives that do not take into account the special characteristics of and demands on the agency -- such as arbitrarily reducing GS levels -- the agency suffers further through a hidden depletion of resources.

Some History About Staff and Budget

Inadequate staff and budget are not new problems at the SEC. In 1972, under the leadership of Chairman William R. Casey, the SEC appointed a distinguished bipartisan private sector committee to study and recommend changes in the SEC's enforcement activities and procedures. John M. Wells, a senior partner in the law firm of Rogers & Wells, chaired this Committee, which came to be known informally as the "Wells Committee." The other two members were Manuel Cohen and Ralph Demmler. Each was an attorney in private practice at the time; each was a former Chairman of the SEC.

The Wells Committee made a number of recommendations to bring greater fairness to the enforcement process. The Wells Report went further, however, and spoke about the adequacy of SEC resources, concluding: "The Committee did not undertake the kind of review that would be necessary to

Senator RIEGLE. Thank you. I appreciate that offer. I do want to take you up on that offer, so we would like the detailed recommendations and we will be in touch with you to pursue those ideas.

Mr. Pitt, you and others have suggested the need for a definition of insider trading and we were talking about that earlier in the day here, as you know.

You say in your testimony:

> The substantive law applicable to insider trading should be overhauled to remove uncertainty, clarify the misappropriation theory and define the concept of insiders.

It's my understanding that members of the ABA subcommittee on SEC practice and enforcement, which you chair, include many of the leading practitioners of the Securities Bar.

And I'm wondering what your reaction would be if I were to ask you and the members of your subcommittee to come up with a proposed overhaul of the law applicable to insider trading that you would recommend and that as part of that if you, in doing so with your subcommittee, would be willing to work or at least touch base with people like John Olsen, Lou Black, Gary Lynch, and the Commission and other Commission members, as Irving Pollack and Judge Stanley Sporkin, if he's able to do so, in getting a blend of opinion in order to develop such a proposal.

PROPOSAL ON INSIDER TRADING

I'm wondering if you would feel that you could do such a piece of work as that to give us a proposal of that kind and do it on a timely basis, say within 90 days. Is that something that you would be willing to undertake to do? Obviously, it would be one of many inputs that we would have, but it seems to me what we need is to capture this problem in terms of some serious recommendations from people who are professionals at arm's length who have something to say, and then we can deal with those recommendations. We may modify them, accept some, reject others, but would you be of a mind to be willing to take on that kind of an effort along those lines?

Mr. PITT. Yes. Let me just say in response, I would be willing to canvass the members of the subcommittee and the other individuals you mentioned.

I think it's particularly important to bear in mind several things. One is that the ABA has had a task force which has looked at this issue and its efforts provide a very good starting point for this effort and that's why I think John Olsen in particular is an excellent choice as someone who ought to be involved.

I also think that the Commission should have input in this process. The Commission's great concern in this area is that any new law should not foreclose possible enforcement opportunities. As a result, the Commission's input at least ought to be available to this committee so that you can evaluate a recommendation coming from the private sector, in light of the Commission's views about its likely enforcement prerogatives.

It's not unheard of that the private sector and the Commission don't always agree.

Finally, I guess the only other thing I would say is that obviously a number of people on the ABA subcommittee that I chair obvious-

ly have ongoing client representations. I believe that each of us is capable of dealing with these issues in a way that insulates any product of our subcommittee from bias. I think the more people who have a chance to look at it, the more secure this committee will be that no one particular influence could affect that.

Subject to the caveat that anything that was generated out of this effort would not be an official ABA product, since 90 days and maybe 190 days would not suffice to get the ABA's mechanism to endorse it officially, I would be honored to try and undertake your project.

Senator RIEGLE. I think that would be helpful to us and I think we have to get some professional work done of this kind in order to help us sort of collect this problem in a way where we can deal with it better.

Let me move to a different question. That is, there were discussions earlier today about whether the Chinese wall—and I wonder whether people who might be watching this on C-Span understand what the Chinese wall is—but it's supposed to be a barrier within an investment company that prevents certain activities from leaking over into other activities and having some contaminating effect.

I am wondering if it's possible to preserve—in your respective views and I'd like to ask each of you to comment on it—as we've seen the rise of these multidepartment firms with all of these myriad of activities, which have been touched on today—underwriting, junk bond underwriting, mergers and acquisitions, leverage buyouts, new product creation, venture capital investing, securities trading, arbitrage and others—all operating under the same roof and with the same pool of capital, are we facing a difference where the ability to really sufficiently maintain an effective barrier internally, or a Chinese wall as it's called and how ought we to see that problem?

Mr. Cohen, let me start with you.

Mr. COHEN. Well, I think the subject should be explored, but I am skeptical as to how successful the reliance on Chinese walls can be for the reasons you have indicated. If you have two departments, two activities, it's perhaps easy enough to have a Chinese wall between those two, and that's the way the idea originated a few years ago. Now the firms have so many activities because they're in so many different markets, so many different products, so many different forms of proprietary trading on their own, and so on, that it becomes very hard to see how firms of that nature can create some Chinese walls that will be effective.

To go back a moment to the insider trading subject, that started as a question of corporate information but nowadays the much more difficult question is market information, that is, what's going on in the market that is going to affect prices even though it isn't affecting the underlying company. And when you get into that area, you've got a whole spectrum of difficulties, starting with the question of whether, when a large institution or a broker-dealer firm is going to handle a big transaction for itself or for a customer, it must tell everybody it's about to have that transaction. It's been generally agreed that the answer is no, you don't have to consider your own transactions as inside information.

But when you then go on to where a partner or employee uses confidential information about that transaction or somebody else is tipped off to that transaction, the answer may be different. Arriving at a satisfactory definition of insider trading—which I agree is a very worthwhile effort to undertake—will not be easy. I believe the question of how effective Chinese walls can be should also be explored but again I don't think the answer is going to be easy to come by.

Senator RIEGLE. Just briefly, do the other two of you wish to comment?

PROBLEM OF PUBLIC PERCEPTION

Mr. PITT. The only comment I would make is that the problem isn't really just the law, it is public perception, and I think the Commission itself has indicated this and many of the firms on Wall Street are aware of this. A firm that is privy to inside information, regarding a particular stock may also, because its Chinese wall insulates that information from other departments within the firm, nevertheless endorse the stock. Such an endorsement may subject the firm to criticism by investors who do not understand the issues. And the Commission itself, in its release adopting 14(e)(3), has said that when a firm acts as an investment banker for a merger deal, it really shouldn't be trading for its proprietary account in the same stock.

As a result, I think that a view as to how the Chinese wall can be made more effective is important. As a pragmatic matter, firms have to decide for themselves, when they become aware of material information, whether to cut off certain activities, or whether the cutting off of that activity will provide a separate tip to the Street.

Mr. TREADWAY. I am not ready to throw the Chinese wall out. I think in many cases, it is a question of internal control and the firms must recognize that the very developments you have named, each of those puts a pressure on the Chinese wall, and you've got to have more bricks there. If you couple that with corporate and up the line responsibility, if there is a leak in the dike, I think that that is an approach that I would want to try first.

I just also observe that some of the cases that have been in the news recently do not involve a breach of the Chinese wall; they involve allegations of an individual in one firm leaking information to an individual in another. So it is not a violation of the wall within the firm. The pressures are very real. I don't minimize them.

Senator RIEGLE. Let me just ask you one other thing before turning to Senator Armstrong, and that is this.

Mr. Cohen and Mr. Treadway, you have heard me ask Mr. Pitt, if he would be willing, within his ABA subcommittee effort, to try to take an independent look at this and see what recommendations they might make to us. I would like any suggestions that either of you have as to what ought to be the focus of that kind of a study effort.

Mr. COHEN. Yes, sir. I will try to be helpful.

Senator RIEGLE. I mean, do you have any thoughts right now for the record?

Mr. COHEN. No, I guess not.

Senator RIEGLE. Mr. Treadway, do you, at this point?

Mr. TREADWAY. Well, I guess—I would be delighted to. I participated while I was at the Commission in trying to work on a definition and gave up in frustration, I have to admit. It is a tough situation. I do think that one can be worked up, and I would be delighted to work, but would hold off on specific recommendations today. But I would be delighted to be involved.

Senator Armstrong.

Senator RIEGLE. Very good. It comes off our earlier discussion, Senator Armstrong, which you were very much a part of, and that is what constitutes insider trading, and when you put the question to our earlier panelists, there was something less than a clear consensus.

Senator ARMSTRONG. Mr. Chairman, I think what you have suggested is a great idea. We need some help, but I am going to tell you, if there is one thing that is obvious, if it is going to take this distinguished bunch of lawyers 90 days to figure out what insider trading is, we really do have a problem. We've got a serious problem of holding people accountable for something which even the experts cannot presently define and are not sure whether they can define in 90 days, and don't think they could get the ABA to agree on, even in a longer period of time.

Mr. TREADWAY. I think you will find that the experts will probably be in agreement on 80, 90, or 95 percent of the definition, that is probably a small range of activity.

Senator ARMSTRONG. I am sure that is true, Mr. Treadway, but let me just tell you as a businessman. You see, you guys are all lawyers, and I am not. I, in my real life capacity, am in the business of employing lawyers, and all the time I call them up, not about securities law. If I had any securities law transactions, I wouldn't be on this committee. But I call them up, and I say, what about this? Can I do so-and-so? And it drives me nuts when they tell me, we can't answer that question. We don't know. We think it is 60-40, you can do this, that or the other thing. And that is bad enough when it involves a business judgment decision of whether or not I may go forward with a deal or I may not go forward with a deal,

But when you are talking about something that involves criminal sanctions, and which potentially involves the rights of thousands or even tens of thousands of shareholders and big companies, I think it is a serious situation, and I would really encourage you, if you formulate this definition, to define as clearly as you can, as much as you can, and then help champion the cause of not forbidding anything which you cannot clearly define. The notion of having a catchall clause that says—that leaves what Mr. Marron characterized as a gray area, is just abhorrent to what we are doing around here. I am not saying that the SEC law is worse about that than others. We have the same thing in other areas, and it is rephrensible wherever it exists, and it just violative of good policy.

Mr. COHEN. May I make a comment, sir?

Senator ARMSTRONG. Yes, sir. Lead us out of this wilderness!

Mr. COHEN. I think the problem that you talk about is a very real one, and certainly there ought to be a solution to it, if it can possibly be found. But I would like to point out that from the beginning of the statute, there have been the words "fraud" and "manipulation" and many attempts have been made to define those terms more precisely without limiting them, and the attempt has been basically given up, except as they have been defined through case law.

So enforcement in those areas is some combination of statutory concepts and what you might call a common law under the statute. Now to the extent that you can codify and be specific or give safe harbors or give unsafe harbors, by way of partial definition, I would be all for it. Whether you can have an exhaustive definition, I don't know.

NEED FOR CLARITY

Senator ARMSTRONG. Mr. Cohen, I am not necessarily arguing for codification, I am arguing for clarity, and that can arise as easy through case law as any other way, but that is not where we are today.

Mr. Pitt makes the point very forcibly that, indeed, the Commission seems to eschew regulatory proceedings, seems to avoid bringing matters to a head in a regulatory process with comments from interested persons, where there is a chance for everybody to comment on it and for everybody to be on notice that a change is about to occur. In fact, I comment to the subcommittee his statement on page 7 and elsewhere in his statement, where he makes the point that they deliberately don't do it that way, that what they instead do is break new regulatory ground by enforcement. And I am moved to ask Mr. Pitt, why do they do that? Why don't they have, if they want to make some new law, why don't they just go ahead and make it? They've got regulatory power. Why don't they promulgate regulations instead of going out and hauling up some poor devil before the bar of justice for something which has never previously been an offense?

Mr. PITT. Well, there are two responses. First, the Commission will tell you that in many of the cases, they think they are simply extending well-accepted principles of the law to, perhaps, brand-new situations. I tend to disagree, based on the vantage point of advising clients, and I might say, a good deal of my practice is responding to the type of telephone calls you have described in the trading arena. That is incredibly frustrating when people call up, and they need to know whether they can do a trade immediately, and the law is not clear. One ends up advising people, not so much on what the law is or isn't, but on how risk averse they ought to be in a particular set of situations.

The second reason the Commission does it is because enforcement is easier. They are afraid to tackle rules, where they are concerned that, by setting out the parameters, they will let some egregious cases get away. This is one of the problems that we have had with the definition in the past.

What the Commission really needs to know is that it has the assurance from this committee and the private sector, that if a mis-

take is made, and they can find egregious cases that aren't covered, we can amend the law, or that there is enough flexibility in the law to deal with the truly egregious cases that should have been covered by congressional enactment.

Senator ARMSTRONG. Well, your point in your statement, in your written statement was that they could promulgate rules, which would be within their power to amend themselves. Did I misunderstand your point?

Mr. PITT. No. My point is that there are many areas where the Commission has the authority already or could have had the authority, based on an interpretation of the law, and has failed to utilize that power. Some of that is due to this concept of deregulation that we have talked about. The Commission may also be concerned that if it admits that something isn't covered now and the rule doesn't pass, because of criticism or otherwise, the next time it tries to enforce that policy against somebody, you are going to be told that the law doesn't cover it. I think that, in a sense, it is an unfortunate approach to the law that has been engrained over the years. And in the fraud area, there is a certain degree of validity to the fear that if you define fraud too specifically, you may let some ne'er-do-wells go free. But I think the Commission has the capacity, and so does this committee, to define these principles in a way that gets the law where it ought to be.

Senator ARMSTRONG. Mr. Chairman, I've got a couple of other matters I want to raise, but before we leave this issue, I want to ask you to take a look at Mr. Pitt's statement, and particularly his footnote 11, which outlines the circumstances of a case that I just want to mention, because it is so typical of the kind of concern which I feel, I don't know how widespread it is. My guess is, it is a fairly common kind of situation, and if I understand your footnote, it is that one Raymond Dirks tried to put some material in the Wall Street Journal, couldn't get it planted there, and then went ahead and acted upon the information which he tried to get on the public record. And when it couldn't get on the public record, he went ahead and told his clients to sell or buy or whatever it was he told them. And then the SEC hauled him up on some kind of charges.

Is that a fair statement, broadly fair?

MISAPPLICATION OF SEC ENFORCEMENT RESOURCES

Mr. PITT. It is a fair summary of the way many of us perceive that case, which I think was a misapplication of precious SEC enforcement resources.

Senator ARMSTRONG. Well, that is just an outrage, and just for the record, I think it is an outrage. And I mentioned earlier in the day that I had occasion to get pretty deeply involved in the way the Justice Department and the IRS handles tax cases. And that is the way they do stuff all the time. I have just seen enough smoke that makes me think this should a broad concern of the Congress about the way all of these agencies, perhaps included the SEC, I am not sure of that yet, but perhaps including the SEC, do business. That you know, we get perilously close to the point where it

is regulation by the lifted eyebrow every day. And I understand there are close calls and all that.

I want to ask two quite specific questions, if I could, about the Chinese wall first.

Do you all agree that the Chinese wall is either working or is workable? Anybody disagree with that? That it's either OK or it is fixable?

Mr. COHEN. I think it is workable for some purposes, but it cannot be fully relied on with modern firms having all the complexity that they have.

Senator ARMSTRONG. Well, the reason why—and let the record reflect that, in addition to Mr. Cohen, that the others nodded they thought that was the case. When we were considering legislation to grant securities powers to banks, the argument of the securities industry was that it was insufficient to put the securities power in another subsidiary of a bank holding company? Do you remember that argument?

Senator RIEGLE. Yes, indeed.

Senator ARMSTRONG. And in fact, it was persuasive to me. They convinced me that no matter how many walls of separation you build into this giant banking conglomerate, that there would be leaks. We didn't call it a Chinese wall, we called it something else. I note in passing that there is a certain richness of metaphor in all of this.

But is there any reason why we should be led to believe, on the one hand that the Chinese wall works to separate mergers and acquisitions from arbitrage within a firm but would not work equally well to separate functions, of, say, commercial banking from securities underwriting in a banking firm? Are they conceptually any different?

Mr. PITT. Well, I hesitate to respond fully, because I represent clients with major interests in that area. But I believe that there are enormous conceptual differences, not the least of which is that, prior to the adoption of the Glass-Steagall Act in 1933, there was fairly detailed study of the abuses that had occurred where securities affiliates had been allowed to exist, and that practice had been largely credited with some of the problems.

My own view is that while Congress can conclude that circumstances have changed and that Congress is the appropriate vehicle if any change is to occur, there is at least a predicate for the conclusions that led to the Glass-Steagall separation.

Senator ARMSTRONG. Sure, but my question is, why do we believe that officers of a firm, working in separate isolated departments can be trusted to remain separate and isolated with respect to M&A activity and arbitrage, on the one hand, but not securities underwriting and commercial banking on the other?

I mean, what is the conceptual difference there?

Mr. PITT. Well, the only comment I will make to that is the observation I offered a few moments ago: that even the SEC suggested that, as a pragmatic matter, the inflow of confidential information into one portion of the firm under the context of merger and acquisition work should probably disable the firm from trading from its proprietary account.

So the efficacy of the Chinese wall is really to deal with the situations in which trading has occurred accidentally. The SEC's rule 14(e)(3) can sort of be analogized to a "pure heart and empty head" standard, which is that you didn't intend to trade on the information, and you, in fact, didn't have the information. The Commission has said there will be a safe harbor from liability in that situation, but they nevertheless encourage firms not to engage in that kind of conduct.

Mr. TREADWAY. I was just going to say, conceptually, I don't see the difference.

Senator ARMSTRONG. You do not see the difference?

Mr. TREADWAY. Conceptually. I think, you know, there are other issues you can argue on the Glass-Steagall question. Are banks special? Should they be protected, and a lot of other issues. But that is a different—but that is my point, but conceptually.

Senator ARMSTRONG. Sure. Thanks, Mr. Chairman. I see my time has expired. I thank the witnesses for their very interesting testimony.

Senator RIEGLE. Thank you, Senator Armstrong.

I am going to just pose one more question, and then Senator Proxmire will chair the remainder of this session today, and he has some matters to raise with you.

Two of you, Mr. Cohen and Mr. Pitt, you have suggested the need for an independent special study on the overall capital market situation today, with all these new instruments and activities, and so forth.

I think that may be a good idea, but give me a little better understanding, if you can, as to exactly what you believe ought to be the focus of that kind of independent assessment of where we are and where we are heading, and how might it be established and conducted.

I would like a brief answer, because time is late for you and others, and I want to get to Senator Proxmire.

CAPACITY FOR THE SEC TO UPGRADE ITS OPERATION

Mr. COHEN. Well, later on in my statement that I didn't get to, I say that I don't suggest a particular form that that should take. I think there should be a capacity within the SEC and an agenda within the SEC to keep up with things and to have people qualified to study some kinds of things in some depth, not just statistics.

Now you can do that in either one of two ways. You can wait until you have accumulated lots of questions as happened in 1961 and then hire a special staff to look at them in depth for a year or so and come up with conclusions and recommendations about lots of subjects; or the Commission can have a capacity to engage in necessary studies on a continuous basis, which goes to the question of resources. I think the Commission's resources are strained. They are strained in numbers. They are strained in expertise, and they are strained in the ability to free some people up from routine work, so that they can be looking at these subjects as they need looking at.

Senator RIEGLE. But the point is, is that you feel that we are at such a point that that kind of capacity is needed now to take a

determine the appropriate size or shape of the Commission in the years ahead.... Our general impression, however, is that the Commission should establish a goal of doubling the size of its total staff over the next five years." (Emphasis added.)

That 1972 recommendation of the Wells Committee was preceded by the following observation:

"The Committee found it highly instructive to compare the size of the Commission's staff in June 1941 with its size in June 1971, over 30 years later, and then to look at the changes in the Commission's responsibilities over the same period. The selection of the 1941-1971 period was not fortuitous. By 1940, with the adoption of the Investment Company and the Investment Advisers Acts, Congress had completed the basic framework for regulation of the securities industry. The Committee found that over that period the Commission's staff had actually declined in numbers from 1,711 to 1,410. While more members of the Commission's staff in 1941 were engaged in the administration of the Public Utility Holding Company Act of 1935 than were so engaged in 1971, the present staff level still seems unwisely low in light of the dramatic expansion of the Commission's other regulatory responsibilities."

The Wells Committee was not alone in its view that the SEC's budget and resources are substantially inadequate. In 1971, the following exchange occurred between SEC Chairman Casey and John Moss, Chairman of the House Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce:

"Mr. Moss. Are you satisfied that the old Bureau of the Budget and more recently the Office of Management and Budget have, over the years, approved adequate budgets for the Securities and Exchange Commission?"

"Mr. Casey. I don't believe that they have. In fact, going back over the years. I think the Securities and Exchange Commission didn't request adequate budgets; when it did request budget increases, too frequently their requests were reduced by the Budget Bureau, and then too frequently were further reduced by the Congress." */

*/ Hearings Before the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce of the House of Representatives, 92nd Congress, 1st Sess., Oct. and Nov., 1971.

This exchange underscores that the present and recent Commissions did not create the budget/resource problem. They inherited it. The problem has been around a long time.

Furthermore, efforts of the present Commission to increase productivity and efficiency ought not to be met with harsh criticism. Productivity ought to be encouraged. The present Commission is merely continuing a long tradition of attempting to deal with inadequate resources with higher efficiencies.

The 1976 SEC Annual Report (Roderick M. Hills, Chairman) stated: "A number of important developments occurred in 1976, contributing to increased operating efficiency, improved service to the public, and effective use of the Commission's resources."

The 1979 Annual Report (Harold Williams, Chairman) stated:

"During the fiscal year 1979, the Commission stressed, more than ever before, its commitment to improving management information systems and strengthening internal management capabilities. This heightened emphasis on enhanced administrative and managerial support is a direct reflection of increased recognition of potential benefits that can flow to the public from better systems, procedures, plans, and organization structures. It is intended that the initiatives of 1979 will emerge in the form of operational economies, increased effectiveness and greater responsiveness in the 1980's."

IV. Additional Requirements, Remedies, and Sanctions.

The Committee's request for testimony also asked for comments on any additional requirements, remedies or sanctions that might be appropriate for the SEC. To respond to that request, I would like to share certain aspects of the work of the National Commission on Fraudulent Financial Reporting. As part of our efforts at the NCFFR, we have inquired into those sanctions and remedies which might be appropriate to deal with one form of securities law violations, fraudulent financial reporting. Our recommended changes in remedies and sanctions, may or may not have application generally, but they are as follows:

1. More Sanctions Generally. As a general proposition, sanctions imposed on those who violate the law by their involvement in fraudulent financial reporting are not adequate. The NCFRR engaged The University of Southern California to study the role of the SEC in the financial reporting process, including looking at sanctions imposed on violators. A large universe was surveyed, including CEO's,

CFO's, accountants, attorneys, and the general public. An overwhelming number -- 83% -- supported a significant increase in sanctions.

2. Bars of Corporate Officers and Directors. Some have charged that the injunction -- the SEC's principal enforcement tool -- is a meaningless wrist slap, that more is needed. The NCFFR does not agree that the injunction is totally ineffectual; it can be quite severe at times. Nonetheless, the NCFFR will recommend that barring from corporate office those who cause, aid and abet, or participate in fraudulent financial reporting is an appropriate sanction, and one which ought to be regularly considered by the SEC in enforcement proceedings involving fraudulent financial reporting. Rule 2(e) of the SEC's Rules of Practice allows the SEC to bar or limit the activities of individual auditors and firms involved in fraudulent financial reporting, and the NCFFR perceives no logical reason why those with primary responsibility for accurate financial statements should not be subject to equivalent sanctions.

3. Criminal Prosecutions. The NCFRR also believes that more criminal prosecutions and longer sentences for fraudulent financial reporting are appropriate. Although the SEC lacks criminal prosecutorial powers, the NCFFR will recommend that the SEC undertake an organized, affirmative program to educate and to encourage authorities with those powers to take a greater interest in criminally prosecuting those engaged in fraudulent financial reporting.

4. Fining Authority. The NCFFR will recommend that the SEC have fining authority as a general enforcement tool. Such a tool could enable the SEC to fine-tune the sanctioning process, differentiate among degrees of offenders' culpability, and extract any benefit gained by wrongdoing, as the SEC does now with insider trading.

5. Cease-and-Desist. The NCFFR also will recommend that the SEC have cease and desist authority.

In addition to the foregoing remedies and sanctions, the NCFFR also will recommend changes in certain SEC regulatory requirements as they relate to the financial reporting process. These include:

1. Mandatory Audit Committees. Audit Committees, composed of independent directors, should be mandated for all publicly-owned corporations, subject to a limited exemptive process.

2. Audit Committee Chairman's Letter to Stockholders. The SEC should require the Chairman of the Audit Committee to include in the Annual Report to Stockholders a letter

describing the activities of the Audit Committee for the past year.

3. Management's Acknowledgement. The SEC should require that corporate management affirmatively acknowledge in the Annual Report to Stockholders that they have the foremost and ultimate responsibility for accurate financial statements.

4. Management's Opinion on Internal Controls. Corporate management should be required to express an opinion on the adequacy of internal controls.

5. Mandatory Internal Audit Function. All public companies should be required to maintain an internal audit function.

6. Codes of Conduct. All companies should adopt, publicize and enforce written codes of conduct which, among other things, deal with the obligation to account accurately to stockholders.

7. The ASB and Public Participation. The Auditing Standards Board should be reorganized to include substantial representation and participation on the part of knowledgeable representatives of various constituencies affected by or involved in the financial reporting process.

8. Revising the Standard Auditor's Report. The standard auditor's report should be revised to communicate better the auditor's role and responsibilities -- including those related to fraud detection -- as well as the inherent limitations on the auditor's ability.

9. Mandatory Membership in a Quality Assurance Program. The NCFFR will recommend that the SEC mandate membership in a professional quality assurance program such as the American Institute of Certified Public Accountants SEC Practice Section (or its equivalent) for all auditors involved in audits of public companies.

10. Opinion-Shopping and Second Opinions. The NCFFR will recommend that, if and when a change in auditors occurs, public companies should be required to disclose the nature of any material accounting issues they discussed with their old and new auditors during the three-year period preceding the change. These requirements should apply with equal force to first time registrants.

11. Auditor Involvement in Quality Finance Reports. The NCFFR will recommend that the independent accountants be required to conduct a timely review of the issuers quarterly financial reports.

V. Conclusion

I thank the Subcommittee for its invitation to testify and hope my comments have been useful.

To summarize, the tenor of my comments evidences a very high degree of support for self-regulation, for the SEC, and for its general direction. My principal recommendation for changes concentrate on the need for substantial increases in staff and other resources, and a substantially larger budget.

I personally support efforts to control the federal budget. But the SEC, particularly in recent years, has been more than self-supporting -- it has returned dollars to the Treasury -- it has become a profit-center for the federal government. I can think of no reason why the SEC's fee schedule -- perhaps adjusted from time to time -- should not make the SEC self-supporting in virtually all years. Any increased cost that might be imposed on reporting companies, regulated entities, and others could be spread over such a wide universe that it would represent an infinitesimal increase to those charged. Considering that demands on the SEC have exploded and that even a substantially increased budget for the SEC would have no impact on the size of the federal budget, the case for a substantial increase is overwhelming.

Yet, as long as the SEC is "just another agency" in the eyes of budgeteers, subject to the general budget process, standard pay scales and pay-caps, and standard requirements with respect to the number of high level GS grades OMB will tolerate, I fear that the budget/resources problems of the SEC will continue more or less the same. In 1992 and 2002, I expect we will be hearing the same theme we heard in 1971 from then Chairman William Casey and in 1972 from the Wells Committee: that the agency is and has been chronically strapped.

The only realistic alternative may be to remove the SEC from the regular budget process and to view it as a financially self-sustaining agency (like the Comptroller of the Currency, for example). That change would allow the SEC's operations and activities to be determined by focusing first on the SEC's statutory mandates and having a substantive discussion about what the SEC needs to do. That would be a substantial departure from the current process, which is largely budget-drived, and in which dollars expected to be available to "just another agency" dictate the SEC's scope of activities.

Such a change would not necessarily exempt the SEC from various checks and balances in our system I do not believe that the Comptroller is running amuck -- nor would it necessarily reduce Congressional oversight. That oversight could be exercised as vigorously and effectively as ever.

I offer this suggested restructuring most seriously. If this Subcommittee, other Congressional Committees, or the SEC wish seriously to consider this concept, I would be pleased to make a substantial commitment of my personal time to working with them in an effort to achieve that change.

fresh look, however it is done, in terms of the institutional arrangements. You think we are at a point where we need that kind of an independent assessment.

Mr. COHEN. Judge Sporkin suggested that there ought to be a study like the one in 1963. I don't think it has to take that form, where you hire 100 people from the outside, but I think that the capacity to do studies as needed is missing and ought to be there.

Senator RIEGLE. Mr. Pitt, what is your thought on it?

Mr. PITT. I do think we are at a point when independent assessment is needed for a number of reasons, but most importantly, because the question is whether our current system needs some major legislative revision. I think we could pinpoint a number of issues where Congress has a fairly good factual predicate for legislative reform, but whether more involved legislation is necessary seems to me to be the overarching question; that is why I would suggest that there ought to be such a study, but it ought to be done under the auspices of the Congress, because its focus ought to be to satisfy the public that, through a panoply of various interests and with a variety of viewpoints, we have explored a number of the deeper questions that can't get answered quickly in one session perhaps. Then the study may lead to specific legislative recommendations.

Senator RIEGLE. If you've got a thought as to how that might be structured, you know, I would like to hear that, either now or later, as to how that might be set in motion to do, because my feeling is, too, that we have sort of evolved very rapidly into a new condition here, especially with the internationalization aspect which nobody is quite clear on.

Mr. PITT. I think that is right, and without trying to elaborate now, I think there are two models, in addition to Milton Cohen's special study. I think the Pecora hearings right before the enactment of the base legislation, and then this subcommittee's study from 1973 to 1975, leading to the 1975 Act amendments, in which I was involved, are the best examples of something that really gets an in-depth look at major issues but has a legislative orientation, which I believe is critical at this point.

Senator RIEGLE. I see.

Thank you very much.

Senator Proxmire, would you want to now take over, which you are quite able to do as the chairman of this full committee at any time.

Senator PROXMIRE [presiding]. Mr. Cohen, you say on page 14 of your testimony, and I quote:

> It appears to me that the dynamics of a takeover contest are affected, if not dominated, by the activities and the self-interest of ancillary players.

It appears that investment bankers and arbitrageurs are spurring takeovers, not to structure companies to compete more effectively but rather to make huge profits for themselves, often through illegal means.

Is that right?

Mr. COHEN. I don't think the last part of what you just read were my words.

Senator PROXMIRE. No, no. They weren't. That is part of my question.

Mr. COHEN. I was addressing this question in terms of the so-called "market for corporate control," which is supposed to be a discipline on management, and I was saying, that before you put so much reliance on the market for corporate control, you ought to consider the fact that what actually happens in takeover contests is often affected by these ancillary players who have their own big stakes involved, big stakes in terms of investments or in terms of fees, and the size of fees, and who are in a position to have a great deal to do with what happens in a takeover contest, quite apart from the merits of the present managers versus the would-be managers.

Senator PROXMIRE. Well, in fact, the ancillary activities are especially conspicuous in view of the fact that so often there is no takeover. It seems to be simply a disguise for an investment pool.

Now Mr. Boone Pickens is a very successful man, of course. He testified before this committee. He has been involved in a whole series of attempted takovers. Not one of those attempts resulted in a takeover, but he has waltzed away with $30 million in one case, $150 million in another. In other words, they bid the stock way up and sell and then Mr. Pickens cries all the way to the bank that he didn't make the takeover.

Mr. COHEN. Well, that is why I think that all these activities that are basically unregulated, except in some very narrow ways, need a total new look as to who is involved, for what purposes, and whether what takeover contests are all about really is discipline over behavior of management.

Senator PROXMIRE. Well, meanwhile, there is a very serious adverse effect.

Mr. COHEN. Yes, sir.

FALLOUT OF TAKEOVERS

Senator PROXMIRE. For example, in the case of Unocal, Unocal's debt went from $1.2 to $5.2 billion. Fred Hartley said that they had to pay $3 million every day they opened their doors, in interest that they couldn't use for research and development or manpower training or new equipment or anything of the kind.

Mr. COHEN. I think a study should be made, not merely as to the market price effect immediately, but on what happens to individual companies on the target side and on the bidder side, because I think a lot of companies have been crippled or hurt because of activities taken on by management in the course of fighting one side or another. I think takeover contests ought to be fought over on the basis of adequate information, adequate time, on there merits, just the way a negotiated transaction is negotiated. Today, too much of it is just based on a kind of blitzkrieg approach as to who can accomplish what, fastest, and make the most money.

Senator PROXMIRE. Well, it is interesting that members of the Senate who are the most consistent critics of so-called merger mania offer remedies which will make it easier to merge. They are against greenmail, they are against the poison pill, against those kinds of defenses.

What would you think of a provision in law that would provide that a firm that acquires 5 percent of a corporation's stock will have to hold that stock for five years, and if they sell it during the 5 years, the profits accrue to the issuing corporation?

Mr. COHEN. I suspect that that might not work in many situations. There might have to be a lot of exceptions to it, Senator, because there can be all kinds of circumstances where someone would make that big an investment with no evil intent or evil consequence. So I think there might have to be lots of leeway in relation to such a rule.

Senator PROXMIRE. Mr. Pitt, among the legislative recommendations you make to stop abuses in our security markets, on page 21 of your testimony, is one calling for an overhaul of our current legislation governing tender offers and related corporation transactions.

Can you give us some specifics regarding that recommendation?

Mr. PITT. Well, I think there are a number of things that have been mentioned here today that I certainly endorse. I think closing the 13-D window from 10 days is long overdue. There is virtual unanimity there is technological capacity to deal with that. And in many respects, I am surprised that we haven't been able to get a consensus sufficient to get legislation on that. And I think this committee and its counterpart in the House have tried to do that, and I think it is something that ought to be done.

There are other areas that I have concerns about in the tender offer area, and in reviewing these we need to consider my theme about whether you do address these by legislation or ad hoc, amicus briefs, as the Commission has done. These problems include the unconventional tender offer situations, some of the creeping acquisition problems that we have noted in the markets that you yourself have just alluded to, and questions with respect to financing of tender offers.

One of the concerns, I guess, that everyone should have is keep the balance in play and make sure that tender offers are actually utilized for their intended purpose, which is to provide meaningful alternatives and checks on management, where appropriate. But the play itself should not become more important than the result. I think we have seen a very active market, and it is not always clear that we are looking at real deals. We may be looking at plays.

Senator PROXMIRE. Now in an article in the New York Times on Sunday, William Weld of the Justice Department said, and I quote:

> It is very important for the government to push hard for incarceration for white collar offenders. Otherwise, you send a message that if a person went to Harvard, they are not going to prison.

LENIENT PUNISHMENT

I might add, "if they went to Yale, they are not going to jail." [Laughter.]

Do you agree with Mr. Weld, and what are your views on the lenient sentences that are being handed out to those who have been convicted so far?

Mr. PITT. My view is that the real focus needs to be on the standards of law that are applied and the Commission's capacity to detect violations and enforce the law. I think that sentencing is

really a function of individualized approaches, and they are left to the right people, namely federal judges who have the capacity to temper both justice and mercy and come up with appropriate results. It probably is not appropriate for me to try and comment on——

Senator PROXMIRE. Do they have that capacity, though? Isn't there a tendency that those of who are white collar people like judges or prosecutors or even legislators, I think tend to be more sympathetic to white collar criminals than we are with the people who steal a lot less and commit crimes that are less minor, but get the book thrown at them?

Mr. PITT. I think, in all of these situations, it is incredibly difficult to generalize, Senator. I think people ought to be aware that if they violate the law, the government has the capacity to detect what has gone on and deal with those issues, but I think it is a mistake to try and generalize from looking at individual cases. I have noted that even the prosecutors have commented that they thought some sentences were too light and other sentences were just right, depending on individualized cases. And I think that is the way the system works, and it is probably best that when a judge has all the factors in front of him, he make those decisions.

The fact is that the mere existence of that kind of penalty is something that ought to be known by everyone and understood as the real deterrent.

Senator PROXMIRE. Mr. Cohen.

Mr. COHEN. Specifically on the insider trading aspect of it, nobody has mentioned today, but perhaps it should be mentioned for the record, that there was an enactment within the last few years, the Insider Trading Sanctions Act, which went beyond forcing an inside trader to return his profit. He must return a multiple of his profit, so that very large monetary penalties have been enforced in that way. Further, most of these actions violate fraud provisions of the law which are subject to civil litigation, and we haven't begun to see what civil litigation may ensue from some of these actions.

I agree with Harvey, when it comes to actual sentencing, it is very hard to judge from outside, because, for example, cooperation in the future of an investigation has apparently entered heavily into Levine's penalty and the Boesky penalty, and so on.

ACCOUNTABILITY OF THE FIRMS

Senator PROXMIRE. If we are going to enforce the law, don't we really have to get the involved firms very serious about it? There is a feeling that these firms often do too well. They make millions of dollars from illegal activities. In the case of Kidder Peabody, the report was in the New York Times that two of the people who have been convicted made no profit themselves but the firm made millions.

I have been told by people who work in the industry that the firm itself should be fined, not simply for failure to supervise, which is what they imposed on Kidder Peabody, but much more substantial than that. So that they tell everybody who is involved in any area where there is a substantial opportunity for insider

trading, "Look buddy, if you get involved here, we are going to do everything we can to cooperate with the authorities to see you go to jail. It is wrong. It will demean the firm, and we are going to do all we can to prevent this from happening, and we mean business. If you want to engage in insider trading, don't do it as a member of our firm."

Mr. COHEN. I think the firm's obligation in this respect needs some defining. It comes to such things as character, integrity, and abiding by basic principles of honesty and fair and equitable principles of trade. Those are hard for the SEC or the self-regulatory organizations to take care of as compared to the individual firm.

I think it has to start with hiring people that don't just have high IQ's or high grades at Harvard or Yale, but who give indication of having decent character and integrity. Then there must be continuing emphasis on character and integrity within the firms, including re-training and re-education. I think that is now happening for the most part.

Senator PROXMIRE. I think it is for the most part, but wouldn't it provide an added incentive if the firm knew that it was also a target?

Mr. COHEN. I think the firms know they are also a target.

Senator PROXMIRE. Well, a specific target so that they are going to have to pay a penalty. And it seems to me the penalty, no matter how big it is, may be the least of it. It's the fact that the firm itself, that this firm is being penalized for criminal actions committed by members of the firm. It seems to me that's an incentive for additional action that would discourage any insider trading and would make the firm as a corporate body work with their people in every way they can to show more ingenuity than they have to make sure that their people don't engage in insider trading.

Mr. COHEN. Well, if I disagree with you at all, it's on this point—that if a firm has done what would be considered an ideal educational effort, an ideal definition of what it expects, ideal selection, and ideal surveillance within the firm, then I don't think you penalize the firm because somebody cheated against the system.

Senator PROXMIRE. That's fine. I would agree with that, but it seems to me there ought to be a fine on the firm in the event that they haven't done that, and it would seem that the present failure to supervise is a feeble provision. As a matter of fact, the penalty they imposed on Kidder Peabody was pretty modest, far less than the profits they made.

Mr. Treadway, Mr. Marron of Paine Webber told us earlier that insider trading abuses on Wall Street are more than aberrations. At least in the takeover area, the abuse of the insider information has grown systemic and must be stopped.

Do you agree with Mr. Marron that the abuse of insider trading in the takeover process is systemic? If so, what reforms should we take in the takeover process to stop that type of illegal activity?

Mr. TREADWAY. Senator, I don't have any basis for either agreeing or disagreeing with the use of his word "systemic." I don't know how broad it is. Statements like that always cause me to stop because it suggests that he somehow knows all the undetected

cases that have not come to light yet, and I don't think that's what he meant to say.

I will agree with him in the sense that I don't think these are extremely rare situations.

Senator PROXMIRE. You think they are more common?

Mr. TREADWAY. I think that they are more than extremely rare. I just don't know how to quantify it. It's like trying to quantify the unknown.

TOOLS TO STOP INSIDER TRADING

In terms of what needs to be done, you can really choose any variety of tools. I commented on some potential additional sanctions and remedies for the SEC in my written testimony which included fining, cease and desist, barring people from further association with publicly owned companies in the future. Of course, that already exists now for a broker-dealer.

I would note that the Commission on Fraudulent Financial Reporting which I headed for the last 2 years, a private sector study group, in inquiring about public attitudes towards sanctions imposed on white collar criminals, if you will, although we've asked the question about fraudulent financial reporting—the response is the general belief is that they are not adequate, that they ought to be generally severe all along the line.

I think it's a question of just looking at the whole range and ratcheting everything up a bit. But I think as much as anything, the key is if people know they are going to get caught and the resources of the government are adequate to get them, whether they're going to jail for three years or four years is not as much a determinant as it is knowing I'm going to get caught and go to jail for three years clearly.

Senator PROXMIRE. I have one more question. I apologize. It's 1:30 and we've been in session for four hours now. That's very long for a congressional committee, so I'll just terminate with this question.

I wish each of you gentlemen would comment. We'll go in reverse alphabetical order starting with Mr. Treadway.

In your testimony, Mr. Treadway, you point out a number of limitations and impediments regarding the self-regulatory process. What improvements do you think can and should be made in the self-regulatory process? And I'd like Mr. Pitt and Mr. Cohen to comment also.

Mr. TREADWAY. Well, I think something I suggested perhaps when you were out occurred to me during the course of the questioning is I don't think I have ever seen anyone pull together on a systematic basis data that shows the full regulatory and enforcement resources of the SEC plus each of the self-regulatory organizations—put that together collectively. Then try to measure the universe that's being regulated—the universe of people, plus activity. And I think looking at and trying to evaluate the effectiveness of the overall regulatory structure that way, rather than piecemeal—deciding how effective is the SEC is one piece, how effective is the New York Stock Exchange is another—would be valuable. I don't know how easy it is to do that.

I also think if you were to do that and have agreement on what the universe is to be regulated, again people plus activity, the question would then be, who can do it most efficiently and most effectively? The government or the SRO?

Now layering on top of all that is surveillance and oversight of the SROs on an aggressive basis by the SEC, the people to do it, the resources to do it, and the tools to do it.

Senator PROXMIRE. Thank you. Mr. Pitt.

Mr. PITT. Well, I'm of the view that the place where the self-regulatory organizations can be most effective is in the setting of disciplinary standards or ethical standards. I should say that really goes beyond legal prescriptions and includes market surveillance. That's the place where their expertise is important.

When we start to get into—and I've discussed some of this in my written statement so I won't belabor the issue—but when we start to get into the process where self-regulatory organizations impose discipline based on legal standards, I have some concerns. The self-regulators have demonstrated from time to time the fact that they can be subject to a variety of pressures that don't relate to the merits of particular disciplinary proceedings. I would much rather see an allocation between the self-regulators and the Commission where the Commission takes the major role for enforcing most of the laws and the self-regulators impose ethical constraints.

Senator PROXMIRE. Thank you. Mr. Cohen.

Mr. COHEN. In my written statement I discuss this and I reaffirm the conclusion that we expressed back in 1963 that securities regulation should continue to be based on the principle of giving maximum scope to self-regulation to the extent that a regulatory need can be met, with the government performing an oversight role in addition to its direct governmental role.

That was based on the subsidiary principle that self-regulation can be closer to a lot of what's going on. To have the Government take over everything that self-regulators do would involve an enormous personnel increase. So I think much has to be left to the self-regulators with the government doing an oversight role.

Now among the things the self-regulatory organization have to do is to police what goes on within their own marketplaces. But there are lots of other things that they must do, such as formulating new rules to meet new market conditions and new competitive circumstances, so that they're kept busy all the time. I think they are doing a better job than ever.

The problem is, however, that their job and the whole regulatory job have become different and more complex than ever before. So there really needs to be another look as to whether, given today's circumstances, the job being done by the selfregulators is as good as it ought to be and whether the SEC is giving them enough surveillance and prodding to do things better.

I think the principle remains the same, but it needs to be applied to a more complex set of circumstances today.

Senator PROXMIRE. Those are very helpful responses. Thank you, gentlemen, very, very much. You've been an excellent panel.

The committee will stand adjourned.

[Whereupon, at 1:35 p.m., the hearing was adjourned.]

[Response to written questions follow.]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM
DONALD B. MARRON

Q.1. Some of my colleagues have urged that we must enact tender offer reform legislation designed to curb takeover activity in an effort to curtail insider trading activity. Should any amendments to the Williams Act that we consider be influenced by a desire to eliminate insider trading or are these (insider trading and tender offer reforms) separate issues which should be addressed by separate legislative proposals?

1. Question 1. While there are certainly more opportunities for insider trading in the takeover area, I believe that the need for tender offer reform and insider trading legislation present issues which should be addressed separately. I have recommended legislation to close the Section 13(d) window and to strengthen the definition of a group. Such legislation would restrict insider trading opportunities by reducing the time during which takeover bids remain nonpublic. However, I believe that it would be a mistake to place substantial restrictions on takeover activity for the purpose of reducing insider trading.

Q.2. Some of our colleagues have argued that tougher sanctions are needed to deter insider trading. Are more penalties needed or are more policemen to enforce the existing laws prohibiting insider trading sufficient? Do you think that the sanctions imposed on Dennis Levine were adequate to send a message to Wall Street (2 years in jail, $350,000 in criminal penalties in addition to the millions of dollars in civil penalties)?

2. Question 2. I believe that the current penalties for insider trading are severe enough -- up to five years in prison, a $100,000 fine, and treble damages under the Insider Trading Sanctions Act. The problems are (1) that there are not sufficient policemen on the beat to impose a significant risk of being caught and (2) there are no sentencing guidelines requiring courts to impose prison sentences on persons convicted of insider trading. The answer to the first problem is increased funding for SEC enforcement. The answer to the second is tough sentencing guidelines that will overcome any reluctance of the courts to impose stiff criminal sanctions. Federal prosecutors have expressed the view that courts have been lenient in their treatment of insider traders because they are frequently well-educated, wealthy, first-time offenders. Notwithstanding the two-year prison sentence given to Dennis Levine, most individuals thus far convicted of insider trading have been given probation. If we are going to deter insider trading, we must send a message that our society views the crime as a serious offense. This requires that persons convicted of insider trading receive some prison sentence notwithstanding that they may have exemplary records.

Within the next few days, Congress will receive sentencing guidelines from the U.S. Sentencing Commission which cover insider trading and other crimes. In my opinion, the sentencing guidelines covering insider trading are far too lenient. For example, the guidelines would require a court, absent special circumstances, to impose a prison sentence of 0 to 6 months on a person who makes up to $500,000 in an insider trading scheme. Thus, for cases involving up to $500,000 in profits, the court will retain the discretion of granting probation. I question whether this is enough.

Q.3. What legislation would you recommend to provide added deterrence? Should we provide a statutory definition of insider trading to provide greater guidance to participants in the securities markets? (England, France and, by this summer, Switzerland have or will have statutes on the books that define insider trading.)

3. Question 3. As I indicated in my testimony (page 5), I support efforts to clarify the law of insider trading. Clarification would have two benefits. First, it would give needed guidance to businessmen concerning what is expected of them. Second, it would enhance law enforcement and deterrence. The relative dearth of criminal prosecutions of insider trading before 1978 may be due in part to the lack of a definition of the crime. Prosecutors may have been reluctant to bring cases in situations where the law did not provide clear notice that one's conduct was unlawful. I understand that the crime probably cannot be defined with precision. However, it certainly can and should be improved. The definition should be carefully drafted to ensure that it does not unduly restrict securities analysts from performing their job of ferreting out and reporting corporate information.

Q.4. How can we effectively deter insider trading when transactions can be executed from off-shore locations where insider trading is not illegal? To curtail insider trading, shouldn't we attempt to enter into treaties with foreign countries which require reciprocity or a more uniform policing of securities fraud in the U.S. and international markets?

4. Question 4. As I testified (pages 6, 9), the problem of insider trading from off-shore locations should be addressed through continued efforts to reach bilateral and multilateral agreements with foreign countries regarding access to information. Further, efforts should be made to reach an international definition of the crime of insider trading. This may require that we limit our definition to informational advantages which have been obtained by misappropriation, theft or other illegal means. If our definition is so restrictive that it does not make sense to the average foreigner, it will be difficult to make them cooperate in efforts to prosecute such conduct.

Q.5. Since the enactment of the Federal Securities laws in the 1930's, self-regulation has been a basic tenet underlying securities regulation. Have the recent insider trading scandals revealed that most firms pay only lip service to self-regulation? What steps can the individual law firms, securities firms and corporations take to prevent insider trading? Have these firms been derelict in their duties of sending a clear message to their employees that insider trading will not be condoned by the firm?

Q.5A. In his testimony, Milton Cohen states that self-regulation, in essence, begins with the individual firms. Have the firms failed to adequately self-regulate their trading activities as Mr. Cohen has suggested? What steps have your firms taken to avoid the particular abuses regarding proprietary trading that Mr. Cohen refers to on page 23 of his testimony?

Q.6. Since it appears that self-regulation with regard to insider trading has become somewhat lackadaisical, shouldn't a civil sanction be imposed upon a firm if one of its employees has been found guilty of insider trading and the firm knew or should have known of these illegal activities?

Q.7. Dennis Block, a prominent member of the securities bar, has suggested that insider trading would be less prevalent if a securities firm be prevented from engaging in arbitrage activity where it is also acting as an investment banker to a company involved in a takeover. What do you think about such a prohibition?

5. Questions 5, 5A, 6, 7. Self-regulation should play an important role in preventing insider and proprietary trading abuses. I believe that Wall Street firms have made legitimate efforts to police misconduct by their employees. However, some firms may not have done enough and must be more vigilant in the future.

I do not support the suggestion in question 6 that firms should be civilly liable for the insider trading violations of their employees if they "should have known" of their illegal activities. Employees must be trusted with market-sensitive information for securities firms to operate. When employees take advantage of such information for their personal benefit, they frequently conceal their activities by trading through secret foreign accounts or through the accounts of friends and relatives at other firms. It is far too easy to argue -- with the benefit of 20-20 hindsight -- that the firm should have known of the employee's misconduct.

Nor do I support the suggestion, set forth in question 7, that Congress should impose a prohibition on arbitrage activity by firms who are acting as investment bankers in takeover contests. Some brokerage firms have a "restricted list" which functions as a prohibition on arbitrage transactions in stocks in which the firm is acting as an investment banker. However, many people believe that a restricted list may send a signal to outside arbitrageurs and other professional investors that a stock on the list may be the subject of a takeover. The proposed legislation is subject to the same criticism. Firms and their SROs should remain free to fashion internal procedures which are tailored to their particular circumstances.

Finally, I strongly disagree with the argument, which has been suggested by some, that firms which engage in arbitrage should be prohibited from engaging in investment banking. Placing a wall between arbitrage and investment banking would be a serious mistake. It would place American broker-dealers at an extreme competitive disadvantage with large international brokers which are free to operate both proprietary trading and investment banking departments. The British amended their laws in 1984 to permit their brokerage firms to build integrated securities businesses which can compete on international markets with the giant brokerage firms. "The Fight to Win Back Foreign Business," The Financial Times, Ltd., April 19, 1984; "Survey," The Economist, July 14, 1984, at 3. The British experience suggests that brokerage firms with limited functions can no longer compete with large, multiservice international firms.

Q.8. The Williams Act, enacted in 1968, was designed to protect investors by ensuring that both bidders and targets play by a federally mandated set of rules during contests for corporate control. In light of some of the perceived "deficiencies" in the Williams Act, do you think that the Act needs a complete overhaul or more of a fine tuning? What specific modifications would you suggest we make without tipping the balance in favor of bidders or targets -- a balance that the authors of the Williams Act sought to create and preserve?

Q.9. Much SEC analysis and media coverage has been given to the New York Stock Exchange's (NYSE) application to the SEC which would enable the NYSE to amend its one share/one vote listing standards. Do you think that the NYSE listed stocks should be allowed to issue shares with disparate voting rights? Does a movement away from the one share/one vote standard mark the death knell for the concept of "corporate democracy?" Should the management of a company that issues stock with disparate voting rights be restricted or precluded from owning stock with full voting privileges in order to avoid management's ability to entrench itself? For the purposes of voting on issues related to changes in corporate control, should the one share/one vote principle apply to companies issuing stock that have disparate voting rights?

Q.10. Do arbitrageurs play any useful role in corporate takeover contests? Should we consider legislation that essentially eliminates arbitrage activity in battles for corporate control? How could we legislatively limit the arbitrageurs role?

Q.11. In his statement, Milton Cohen is critical of the concept of "bridge financing." What useful purposes does bridge financing serve and should there be any regulation of it? What are the abuses that can result from too great a reliance on bridge financing?

6. Questions 8, 9, 10, and 11. There should be a careful and extensive study of the takeover market before Congress considers any legislation to make major changes to the Williams Act, to impose a one-share, one-vote requirement, to limit the role of arbitrageurs, or to restrict the practice of bridge financing. There has not been sufficient study of these issues to craft sensible legislation. For example, we do not know enough about bridge financing to understand whether it poses undue risks or whether there would be harmful consequences from restricting the ability of American investment banking firms to offer such financing. If bridge financing is prohibited, international banking consortiums may be more than willing to provide the capital for mergers and acquisitions. In these circumstances, legislation would only serve to drive business to foreign competitors. Further, it appears that the NASD and the New York Stock Exchange are resolving their differences over the one-share, one-vote issue. Thus, legislation on that issue appears to be unnecessary at this time.

Q.12. The increased internationalization of the securities market has raised concerns about the ability of the U.S. capital market to remain competitive globally. In his statement, Mr. Shoemaker notes that steps must be taken to ensure that the U.S. market not become outmoded due to regulatory impediments. In the face of increasingly internationalized markets, how can we hope to impose the regulatory standards embodied in our federal securities laws on foreign markets? How can foreign markets be expected to adopt our investor protection and disclosure when their recent growth is due largely to the fact that their regulatory standards are lower than ours?

7. Question 12. My answer to this question is set forth in my previous responses to Recommendations 7, 11 and 13. The entire issue of globalization should be studied carefully. Unnecessary restrictions on trading in the United States should be eliminated. Further, it may be possible to create a two-tier regulatory system in which less restrictive markets are created for institutional investors.

Q.13. On February 19, 1987, the NYSE issued a Special Membership Bulletin in which the Exchange "determined that additional resources must be dedicated to meeting our regulatory responsibilities." I am including a copy of this Bulletin for your convenience. Do you feel that the NYSE recommendations are adequate or must Self-Regulatory Organizations take on even more responsibilities than those described in the Bulletin?

8. Question 13. The entire issue of self-regulation in a global marketplace needs careful study.

Q.14. In the testimony of Robert Rittereiser (see p. 7) he states that the development of derivative products such as options and futures when combined with program trading creates a problem of extraordinary market volatility during those 4 Fridays of the year with "triple witching hours."

(a) Is this volatility only limited to 4 triple witching hours each year? (The 114 point swing in the market on January 23, 1987 was not on a triple witching hour Friday; the 120 point drop on September 11 and 12 was not on a triple witching hour Friday.)

(b) NYSE Chairman John Phelan recently expressed his concern that a failure to curtail the volatility of a program trade driven stock market could lead to a 1929-style market crash. Do you agree with Phelan's assessment and how could such a crash be triggered by program trading? How likely is the occurrence of such a market calamity?

(c) What specific regulation of program trading activity is required?

Q.15. Some critics of program trading suggest that it is nothing more than a sophisticated form of market manipulation. How do you respond to such criticisms when it appears that a firm such as Salomon Brothers could turn the market around in a short time based on its own buy orders? (On December 19, 1986, the market was down between 5-10 points during the last half hour of trading. Salomon initiated a buy program and turned the market around by ordering the purchase of $2 billion worth of equities at the close. The market finished up 16.03 points with trading of 118.5 million shares in the final hour.)

Q.16. It appears that the investor who has the potential for downsider risk in a market dominated by program trading is the small investor. Does program trading have the effect of locking the small investor out of the market? Should small investors avoid trading on those triple witching hour Fridays?

Q.17. It appears that program trading is triggered by trends in the options and futures index rather than by more traditional methods of analysis regarding a buy or sell recommendation. What do you perceive as the effects of this major shift from trading stocks, not on fundamentals such as a company's earnings and dividends, but on technical computer strategies that can drastically swing the market in minutes?

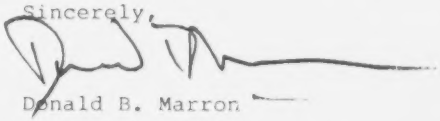
Q.18. How much of your firm's capital is committed to program trading? Are borrowed funds used to engage in program trading?

Q.19. If substantial arbitrage programs are unwound in the same direction late on an expiration day, an extreme imbalance of orders may result that sends the market plummeting. How can exchange specialists attempt to make an orderly market when faced with such imbalances. What's being done to handle a large unwinding of exchange positions in the market? How successful was the plan agreed on by the NYSE and the SEC where so-called market on close orders in certain stocks were required to be submitted at 3:30 p.m. rather than 4:00 p.m. when the market actually closed?

9. Questions 14, 15, 16, 17, 18, and 19. While I understand the concerns about program trading, as I testified during the subcommittee hearing (pages 10-11), I believe that those concerns are overstated and largely unfounded and that legislation at this time is premature. While program trading creates short term volatility surges, it also adds depth and liquidity to our markets. It is part of the sophisticated strategies that are employed today by institutional investors to hedge or manage risks. Individual investors may obtain the benefits of program trading by investing in mutual funds which rely on such programs to enhance their returns.

The SEC is currently consulting with industry experts concerning strategies to limit the volatility that occurs on the four so-called "triple witching hour" days on which options and futures expire simultaneously in the major markets. The SEC has not yet found an effective solution. The SEC's experiment with regulating closing orders on the NYSE has not been wholly successful. However, the SEC is continuing to explore ways of protecting the market and the small investor without precluding institutional investors from using techniques and strategies which have proven beneficial.

Sincerely,



Donald B. Marron

Outline of Some of the Recommendations
Made at the Securities Subcommittee Hearing
February 24, 1987

1. The EDGAR System of the Securities and Exchange Commission ("Commission") deserves the full support of the Congress and should be adequately funded.

2. The Commission should also be developing a vastly improved surveillance capability for all U.S. securities markets.

3. The Commission should be given cease-and-desist powers.

4. The Commission should be given the authority to impose fines as a general enforcement tool.

5. The Commission's traditional injunctive authority should be clarified to confirm the SEC's authority to seek a host of equitable remedies, such as the disgorgement of ill-gotten gains, the appointment of receivers, and the requirement that institutional violators of the federal securities laws be directed to implement prophylactic measures to ensure against a repetition of the violative conduct.

6. The Commission's disciplinary authority over broker-dealers should be clarified, so that there will be no dispute concerning the agency's power to suspend errant professionals for a period exceeding twelve months but less than a lifetime bar.

7. Legislation should be enacted to encourage foreign governments to enter into formal cooperative ventures with U.S. law enforcement authorities, similar to the memoranda of understanding between the United Kingdom and the United States and between Switzerland and the United States, to ensure mutual evidentiary assistance in cases of national importance.

8. Legislation should be enacted to authorize the SEC to require firm's professionals who are privy to market-sensitive, nonpublic information to adopt meaningful guidelines, much as section 17(j) of the Investment Company Act of 1940 requires portfolio managers of investment companies to adhere to standards adopted by their own firms.

9. The Commission's rulemaking authority should be expanded, to enable the agency to cope with changing investment products -- such as financial futures - and changing securities services -- such as the provision of discount brokerage services by depository institutions.

10. A study should be conducted by an independent committee commissioned by, and under the jurisdiction of Congress, with a

view toward recommendations for new legislation and improved regulations.

11. Exchanges should review their listing requirements with a view to eliminating unnecessary restrictions on foreign listings.

12. Congress should establish principles for allocating regulatory responsibilities along functional lines.

13. The Commission should eliminate the Short-Sale Rule which does not exist on the London and Tokyo Exchanges.

14. The Commission's sanctions for those who violate the law by their involvement in fraudulent financial reporting are not adequate and should be significantly increased.

15. Barring from corporate office those who cause, aid and abet, or participate in fraudulent financial reporting is an appropriate sanction, and one which ought to be regularly considered by the Commission in enforcement proceedings involving fraudulent financial reporting.

16. The current legislation regarding tender offers and related corporate transactions should be overhauled to eliminate obvious abuses and to conform the legislative scheme to the realities of today's markets and technologies.

17. Diligent consideration should be given to the elimination of "greenmail" and to a rule that would require full financing of tender offers before they are made.

18. Steps must be taken to assure that disclosures of material corporate information reach the public more quickly and effectively.

(a) Companies that file late or submit incomplete or inaccurate filings should be brought to task by the Commission.

(b) Congress should consider legislation to accelerate disclosure of market sensitive information, including: (1) filing of section 13(D) reports of substantial stock acquisition within 2 days of their acquisition rather than 10 days; and (2) acceleration of 16(A) reports of stock transactions by corporate insiders from 10 days after the close of the month to 2 business days after the transaction.

19. Legislation should be considered that clarifies and strengthens the definition of a "group" so as to assure appropriate disclosure under section 13(D) of concerted or coordinated activities relating to significant acquisitions of stock in publicly-held companies.

PaineWebber Group Inc.
1285 Avenue of the Americas
New York, NY 10019

Donald B. Marron
Chairman and Chief Executive Officer

April 13, 1987

The Honorable Donald W. Riegle, Jr.
Chairman
Subcommittee on Securities
Senate Committee on Banking, Housing,
and Urban Affairs
Washington, D.C. 20510-6075

Dear Chairman Riegle:

The following are my written responses to the recommendations which were made at the hearing before your subcommittee on February 24, 1987, and to the additional questions of Senator D'Amato. I believe that the recommendations and questions provide a constructive framework within which Congress and the securities industry can work toward a common goal: legislation which will restrict insider trading and other abusive practices without interfering with healthy market activity or placing the American securities markets at a competitive disadvantage with other world markets.

To avoid repetition, I have consolidated my responses to related groups of recommendations and questions. As indicated by my responses, I believe that several of the most important issues are too complex for immediate legislative action -- e.g., globalization of the securities markets, program trading and market volatility, the blurring lines between the securities firms, banks, and other financial services organizations, and the role of self-regulatory organizations in a global marketplace. It is becoming more and more apparent that the SEC may not have the jurisdiction, resources or hands-on experience to respond to these new developments. The time is therefore right for a special study commission to examine these issues and to recommend appropriate legislation. However, there are several areas in which Congress can and should act now. These are set forth below.

Responses to Recommendations

1. Recommendation 1. As I indicated in my testimony (page 10), I strongly support the recommendation that Congress should supply the SEC with the resources needed to implement the EDGAR system as quickly as possible. If the American securities markets are to stay competitive, they must be in the forefront of development

and application of new technology. The EDGAR system is long overdue. It will substantially improve market efficiency by improving the manner in which financial information about publicly-traded corporations is collected and disseminated into the market. It will also enhance fairness. The faster that information is made available to investors, the less opportunity there will be for unfair informational advantages. Finally, EDGAR has the potential for enhancing the SEC's surveillance, oversight, and monitoring of the securities markets.

2. Recommendation 2. As I testified (page 10), I agree with the suggestion that the SEC must upgrade its surveillance technology. However, it is important to note that new surveillance technology will not have any value unless the SEC is given the resources to investigate the suspicious trading activity that is detected by that technology. It is therefore vital that Congress provide the SEC with adequate staff resources to carry out its investigative functions.

3. Recommendation 7. As indicated by my testimony (pages 8-9), I support legislation which would encourage foreign governments to enter into formal cooperative agreements with United States law enforcement agencies. The securities markets are becoming globalized. This globalization process will require greater and greater cooperation between securities regulators of different countries. As markets cross international boundaries, the pursuit and deterrence of fraud and other illegal conduct becomes increasingly difficult.

The SEC has done a commendable job of negotiating bilateral agreements with foreign countries on the exchange and release of information. Because of such an agreement, the SEC recently was able to obtain a freeze on five bank accounts in a foreign country which the SEC believes were used in an international insider trading scheme. "Swiss Freeze 5 Bank Accounts," The Washington Post, March 25, 1987, page F3, col. 1. However, legislation may be necessary to achieve the kind of multi-lateral agreements that are necessary to engage in effective policing of fraud in a global securities marketplace.

4. Recommendation 8. I support legislation to require securities firms to adopt meaningful guidelines for their employees who are entrusted with confidential information. Most multiservice firms such as PaineWebber already have policies and procedures designed to prevent misuse of confidential information. These internal

procedures are extremely important in preventing improper use of information. They restrict information on a need-to-know basis, help to prevent leaks, and educate employees that use of confidential information violates firm policy as well as the law. Legislation requiring all firms to have such procedures would be the kind of "joint effort" between Wall Street and Washington which I advocated in my testimony (page 6).

Legislation should not, however, impose inflexible standards which may be unsuitable and inappropriate for many firms. Securities firms have a strong self-interest in ensuring that the procedures are as effective as possible -- domestic and foreign investors may be reluctant to trade in our markets if they believe the markets are dominated by insider trading. For this reason, PaineWebber and other Wall Street brokerage and investment banking firms have already begun a healthy re-examination of existing policies and procedures to determine how they might be improved.

At the same time, it must be recognized that it is difficult to prevent the truly dishonest employee from trading on confidential information through a foreign account or the account of a friend or relative at another firm.

5. Recommendations 9 and 12. I strongly support, as set forth in my testimony (pages 4, 12-14), legislation to allocate regulatory responsibility to the various government agencies along functional rather than industry lines. The rapid growth of new products and services is blurring the traditional lines between broker-dealers, banks, insurance companies, and other players in the financial services industry. The present scheme of dividing regulation along industry lines creates regulatory gaps in which the SEC cannot establish and enforce meaningful standards for the protection of investors. At the same time, however, the securities industry is subject to a confusing, multilayered system of regulation that could stifle the integration of the American markets with other world markets (see my testimony at 4). Legislation is needed to ensure that gaps in protection do not develop, and that unnecessary duplication is eliminated.

6. Recommendation 10. I strongly support the recommendation of a study, along the lines of the 1963 Special Study, covering a broad range of topics, including: (1) globalization of the securities markets; (2) program trading and market volatility;

(3) tender offer reform; and (4) the proper role of self-regulation in a global marketplace. The federal securities laws must be revised to reflect the dramatic changes which have taken place in the American and global securities markets. The issues are far too sophisticated and complex for quick-fix legislation, which might do more harm than good. A study by securities industry experts would provide information concerning the need for and possible implications of legislation.

7. Recommendations 11 and 13. As I testified (pages 7, 8, 9), I support legislation to remove unnecessary regulations, such as the short sale rule and restrictions on foreign listings, which serve as impediments to the integration of the American securities markets with other world markets and needlessly drive business to other markets. Sophisticated institutional investors which desire to invest in foreign equities or to engage in short sales of securities should not be required to take their business to other markets. As indicated in my previous response, I believe that a careful study is needed concerning the entire issue of globalization. However, the elimination of the short sale rule and easing of restrictions on foreign listings may be steps which can be taken without full study.

I should note that the industry and the SEC are exploring means of recapturing some of the business of institutional investors which now takes place in foreign markets. For example, the American Stock Exchange has proposed creating a U.S.-based stock exchange for institutional investors to buy and sell foreign securities which have not been registered with the SEC. "Amex, British Firm Discuss Formation of U.S. Exchange for Foreign Securities," The Wall Street Journal, March 27, 1987, page 26, col. 1. The creation of special exchanges for institutional investors -- which do not need the full panoply of protections designed for unsophisticated individual investors -- is one way of integrating our securities markets with other world markets. Although the SEC has shown some receptivity to the concept of special exchanges for institutional investors, I believe that legislation would be desirable to facilitate the acceptance of such exchanges. Legislation could also stimulate other creative solutions to the problem of integrating our markets with other world markets.

8. Recommendations 16 and 17. I support some revisions to the tender offer rules, such as the elimination of "greenmail" and closing the 13(d) window to 2 days (see my testimony at page 5).

However, I do not believe that more radical changes should be made without an in-depth study of the implications of such changes. There are potentially serious ramifications to obstructing a free and open market for corporate control.

9. Recommendations 18 and 19. I advocated (pages 5, 6) these recommendations during my testimony. I believe that Congress can and should amend Sections 13(d) and 16(a) to accelerate the disclosure of information under those provisions. Further, the SEC and Department of Justice can place greater emphasis on enforcement actions against individuals and companies submitting late or inaccurate filings. However, the recommendation for legislation to strengthen the definition of a group under Section 13(d) is a more complex task. It is difficult to define the concept of a group broadly enough to include all forms of warehousing which should be disclosed without also interfering with some legitimate investment activity. This subject should therefore be assigned to a special study commission.

10. Recommendations 3, 4, 5, 6, 14, and 15. I do not support the recommendations to give the SEC more civil enforcement remedies, such as the power to impose fines, to enter cease-and-desist orders, and to bar or suspend individuals from holding corporate office. There is no evidence that the SEC is being hampered by the lack of adequate enforcement tools. Congress has provided the SEC with the power to suspend or bar securities professionals administratively for misconduct, to obtain injunctive relief against any person who violates the federal securities laws, to obtain treble damages in insider trading cases, and to refer cases to the Department of Justice for criminal prosecution. See, e.g., 15 U.S.C. 78o(b)(4), 78u(d)(1), 78u(d)(2), and 78ff. Further, the courts have construed the SEC's authority to seek injunctive relief as a broad grant of authority to obtain disgorgement and other ancillary equitable relief. In short, as the Supreme Court remarked in one case, Congress has provided the SEC "with an arsenal of flexible enforcement powers." Ernst & Ernst v. Hochfelder, 425 U.S. 194, 195 (1976).

The problem has not been lack of flexible enforcement remedies but rather lack of resources to investigate and prosecute illegal conduct and the failure to use fully the remedies that Congress has provided. Because of the SEC's limited resources, there has not been a sufficient risk of detection to deter certain types of crimes, such as insider

trading, parking of securities, and manipulation. Further, until recently, the government rarely brought criminal prosecutions in the instances where violations of the federal securities laws were detected. Indeed, the Chiarella prosecution in 1978 was apparently the first criminal prosecution of insider trading. 445 U.S. 222, 235 n.20 (1980). This is changing. Recent criminal prosecutions for illegal insider trading, parking of securities, and manipulation demonstrate that the government is beginning to utilize all of the remedies which Congress has provided. These criminal prosecutions, far more than any additional mild civil remedies, will increase the deterrence of illegal conduct. The SEC and Department of Justice should be encouraged to continue the present trend of bringing criminal prosecutions for clearly illegal conduct.

Finally, I have another concern regarding the suggestion that the SEC should be given additional civil remedies -- a concern about fairness. The additional remedies would presumably be enforced administratively outside the judicial context. Respondents in SEC administrative proceedings do not have discovery rights, the right to obtain exculpatory evidence or other fundamental safeguards that are present in the judicial context. I believe that Congress should be reluctant to provide the SEC with additional civil remedies without a demonstrated need for such remedies.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM
RAYMOND A. MASON

Q.1. Some of my colleagues have urged that we must enact tender offer reform legislation designed to curb takeover activity in an effort to curtail insider trading activity. Should any amendments to the Williams Act that we consider be influenced by a desire to eliminate insider trading or are these (insider trading and tender offer reforms) separate issues which should be addressed by separate legislative proposals?

1. The problem of insider trading and tender offer reform are conceptually distinct issues, although it is obviously true that some of the worst recent insider trading abuses have taken place in the context of tender offers. Accordingly, the first focus of any amendments to the Williams Act should be to achieve more effective regulation of the tender offer process itself and the elimination of abuses which may have developed over the years; however, it is quite natural and appropriate for any such amendments to take into account the problems generated by insider trading in the tender offer context.

Q.2. Some of our colleagues have argued that tougher sanctions are needed to deter insider trading. Are more penalties needed or are more policemen to enforce the existing laws prohibiting insider trading sufficient? Do you think that the sanctions imposed on Dennis Levine were adequate to send a message to Wall Street (2 years in jail, $350,000 in criminal penalties in addition to the millions of dollars in civil penalties)?

2. While I would have no objection to tougher sanctions to deter carefully-defined cases of insider trading, I have no doubt that recent enforcement activity by the Commission and the U.S. Attorney have sent a clear message to those who otherwise might be tempted to violate existing law.

Q.3. What legislation would you recommend to provide added deterrence? Should we provide a statutory definition of insider trading to provide greater guidance to participants in the securities markets? (England, France and, by this summer, Switzerland have or will have statutes on the books that define insider trading.)

3. While some of the more egregious recent abuses would constitute insider trading under any conceivable definition, I do agree that a carefully-drafted statutory definition of insider trading would provide greater guidance to participants in the securities markets and would probably handle some of the borderline cases.

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* The numbers below correspond to the numbers of Senator D'Amato's questions. A copy of the questions is attached. No position is expressed at this time with respect to numbers which have been omitted.

Q.4. How can we effectively deter insider trading when transactions can be executed from off-shore locations where insider trading is not illegal? To curtail insider trading, shouldn't we attempt to enter into treaties with foreign countries which require reciprocity or a more uniform policing of securities fraud in the U.S. and international markets?

4. I would support the negotiation of treaties or other arrangements with foreign governments pursuant to which we could achieve a more uniform policing of securities fraud in the U.S. and international markets.

Q.5. Since the enactment of the Federal Securities laws in the 1930's, self-regulation has been a basic tenet underlying securities regulation. Have the recent insider trading scandals revealed that most firms pay only lip service to self-regulation? What steps can the individual law firms, securities firms and corporations take to prevent insider trading? Have these firms been derelict in their duties of sending a clear message to their employees that insider trading will not be condoned by the firm?

Q.5A. In his testimony, Milton Cohen states that self-regulation, in essence, begins with the individual firms. Have the firms failed to adequately self-regulate their trading activities as Mr. Cohen has suggested? What steps have your firms taken to avoid the particular abuses regarding proprietary trading that Mr. Cohen refers to on page 23 of his testimony?

5. and 5A. I believe that most securities firms, and I know that our own, take self-regulation very seriously. The abuses of a few should not be permitted to cast a cloud over the entire industry. Our own firm has clear, and we believe effective, rules and procedures governing proprietary trading.

Q.6. Since it appears that self-regulation with regard to insider trading has become somewhat lackadaisical, shouldn't a civil sanction be imposed upon a firm if one of its employees has been found guilty of insider trading and the firm knew or should have known of these illegal activities?

6. Under certain circumstances, a firm may be held liable under existing law if it knew of insider trading by an employee. Generally, I believe that vigorous enforcement of existing law should be satisfactory in this area.

Q.7. Dennis Block, a prominent member of the securities bar, has suggested that insider trading would be less prevalent if a securities firm be prevented from engaging in arbitrage activity where it is also acting as an investment banker to a company involved in a takeover. What do you think about such a prohibition?

Q.8. The Williams Act, enacted in 1968, was designed to protect investors by ensuring that both bidders and targets play by a federally mandated set of rules during contests for corporate control. In light of some of the perceived "deficiencies" in the Williams Act, do you think that the Act needs a complete overhaul or more of a fine tuning? What specific modifications would you suggest we make without tipping the balance in favor of bidders or targets -- a balance that the authors of the Williams Act sought to create and preserve?

Q.9. Much SEC analysis and media coverage has been given to the New York Stock Exchange's (NYSE) application to the SEC which would enable the NYSE to amend its one share/one vote listing standards. Do you think that the NYSE listed stocks should be allowed to issue shares with disparate voting rights? Does a movement away from the one share/one vote standard mark the death knell for the concept of "corporate democracy?" Should the management of a company that issues stock with disparate voting rights be restricted or precluded from owning stock with full voting privileges in order to avoid management's ability to entrench itself? For the purposes of voting on issues related to changes in corporate control, should the one share/one vote principle apply to companies issuing stock that have disparate voting rights?

Q.10. Do arbitrageurs play any useful role in corporate takeover contests? Should we consider legislation that essentially eliminates arbitrage activity in battles for corporate control? How could we legislatively limit the arbitrageurs role?

10. Legitimate arbitrage activity, not based on the unlawful use of inside information, may often contribute to more efficient functioning of the market and the enhancement of the prices received by stockholders. Accordingly, while carefully crafted restrictions may be appropriate to avoid specific abuses, I do not favor a general prohibition on arbitrage activity in the context of corporate takeover contests.

Q.11. In his statement, Milton Cohen is critical of the concept of "bridge financing." What useful purposes does bridge financing serve and should there be any regulation of it? What are the abuses that can result from too great a reliance on bridge financing?

Q.12. The increased internationalization of the securities market has raised concerns about the ability of the U.S. capital market to remain competitive globally. In his statement, Mr. Shoemaker notes that steps must be taken to ensure that the U.S. market not become outmoded due to regulatory impediments. In the face of increasingly internationalized markets, how can we hope to impose the regulatory standards embodied in our federal securities laws on foreign markets? How can foreign markets be expected to adopt our investor protection and disclosure when their recent growth is due largely to the fact that their regulatory standards are lower than ours?

12. I do not think we are in a position to attempt to compel foreign governments to enact our own views of securities laws. On the other hand, increased international cooperation and moral suasion may prove useful when the ends to be served are clearly in the interest of all countries involved. I believe that the view that the recent growth in foreign markets is "due largely to the fact that their regulatory standards are lower than ours" is overly simplistic.

Q.13. On February 19, 1987, the NYSE issued a Special Membership Bulletin in which the Exchange "determined that additional resources must be dedicated to meeting our regulatory responsibilities." I am including a copy of this Bulletin for your convenience. Do you feel that the NYSE recommendations are adequate or must Self-Regulatory Organizations take on even more responsibilities than those described in the Bulletin?

13. The recommendations appear to be adequate.

Q.14. In the testimony of Robert Rittereiser (see p. 7) he states that the development of derivative products such as options and futures when combined with program trading creates a problem of extraordinary market volatility during those 4 Fridays of the year with "triple witching hours."

(a) Is this volatility only limited to 4 triple witching hours each year? (The 114 point swing in the market on January 23, 1987 was not on a triple witching hour Friday; the 120 point drop on September 11 and 12 was not on a triple witching hour Friday.)

(b) NYSE Chairman John Phelan recently expressed his concern that a failure to curtail the volatility of a program trade driven stock market could lead to a 1929-style market crash. Do you agree with Phelan's assessment and how could such a crash be triggered by program trading? How likely is the occurrence of such a market calamity?

(c) What specific regulation of program trading activity is required?

14. I would like to see an objective, impartial study of program trading, with full participation of all segments of the securities industry and without any preconceptions.

Q.15. Some critics of program trading suggest that it is nothing more than a sophisticated form of market manipulation. How do you respond to such criticisms when it appears that a firm such as Salomon Brothers could turn the market around in a short time based on its own buy orders? (On December 19, 1986, the market was down between 5-10 points during the last half hour of trading. Salomon initiated a buy program and turned the market around by ordering the purchase of $2 billion worth of equities at the close. The market finished up 16.03 points with trading of 118.5 million shares in the final hour.)

15. In some respects program trading is nothing more than a highly sophisticated variant of old-fashioned arbitrage activity. I do not accept the notion that it is merely a "sophisticated form of market manipulation".

Q.16. It appears that the investor who has the potential for downsider risk in a market dominated by program trading is the small investor. Does program trading have the effect of locking the small investor out of the market? Should small investors avoid trading on those triple witching hour Fridays?

16. I believe that institutions as well as individual investors have the potential for downside risk in our markets. I do not believe that program trading has the effect of locking the small investor out of the market.

Q.17. It appears that program trading is triggered by trends in the options and futures index rather than by more traditional methods of analysis regarding a buy or sell recommendation. What do you perceive as the effects of this major shift from trading stocks, not on fundamentals such as a company's earnings and dividends, but on technical computer strategies that can drastically swing the market in minutes?

17. While program trading may cause blips, even significant blips, in the market over the short run, I continue to believe that fundamental factors such as actual and prospective earnings and balance sheet strength are the decisive determinants of stock prices over the medium and long-run.

Q.18. How much of your firm's capital is committed to program trading? Are borrowed funds used to engage in program trading?

18. Our firm does not presently engage in program trading.

Q.19. If substantial arbitrage programs are unwound in the same direction late on an expiration day, an extreme imbalance of orders may result that sends the market plummeting. How can exchange specialists attempt to make an orderly market when faced with such imbalances. What's being done to handle a large unwinding of exchange positions in the market? How successful was the plan agreed on by the NYSE and the SEC where so-called market on close orders in certain stocks were required to be submitted at 3:30 p.m. rather than 4:00 p.m. when the market actually closed?

GENERAL COMMENTS

I would restate my comments during testimony that we should applaud the Securities and Exchange Commission for a job well done, not engage in major overhaul of a system that is the acknowledged best in the world.

Overall computerization of the S.E.C. is long overdue. The EDGAR system is needed and should be completed and implemented. It is equally important to computerize operations of staff and regional offices. Personal computer capabilities would reduce the need for additional staff and increase the efficiency of current personnel.

Outline of Some of the Recommendations
Made at the Securities Subcommittee Hearing
February 24, 1987

1. The EDGAR System of the Securities and Exchange Commission ("Commission") deserves the full support of the Congress and should be adequately funded.

2. The Commission should also be developing a vastly improved surveillance capability for all U.S. securities markets.

3. The Commission should be given cease-and-desist powers.

4. The Commission should be given the authority to impose fines as a general enforcement tool

5. The Commission's traditional injunctive authority should be clarified to confirm the SEC's authority to seek a host of equitable remedies, such as the disgorgement of ill-gotten gains, the appointment of receivers, and the requirement that institutional violators of the federal securities laws be directed to implement prophylactic measures to ensure against a repetition of the violative conduct.

6. The Commission's disciplinary authority over broker-dealers should be clarified, so that there will be no dispute concerning the agency's power to suspend errant professionals for a period exceeding twelve months but less than a lifetime bar.

7. Legislation should be enacted to encourage foreign governments to enter into formal cooperative ventures with U.S. law enforcement authorities, similar to the memoranda of understanding between the United Kingdom and the United States and between Switzerland and the United States, to ensure mutual evidentiary assistance in cases of national importance.

8. Legislation should be enacted to authorize the SEC to require firm's professionals who are privy to market-sensitive, nonpublic information to adopt meaningful guidelines, much as section 17(j) of the Investment Company Act of 1940 requires portfolio managers of investment companies to adhere to standards adopted by their own firms.

9. The Commission's rulemaking authority should be expanded, to enable the agency to cope with changing investment products -- such as financial futures - and changing securities services -- such as the provision of discount brokerage services by depository institutions.

10. A study should be conducted by an independent committee commissioned by, and under the jurisdiction of Congress, with a

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view toward recommendations for new legislation and improved regulations.

11. Exchanges should review their listing requirements with a view to eliminating unnecessary restrictions on foreign listings.

12. Congress should establish principles for allocating regulatory responsibilities along functional lines.

13. The Commission should eliminate the Short-Sale Rule which does not exist on the London and Tokyo Exchanges.

14. The Commission's sanctions for those who violate the law by their involvement in fraudulent financial reporting are not adequate and should be significantly increased.

15. Barring from corporate office those who cause, aid and abet, or participate in fraudulent financial reporting is an appropriate sanction, and one which ought to be regularly considered by the Commission in enforcement proceedings involving fraudulent financial reporting.

16. The current legislation regarding tender offers and related corporate transactions should be overhauled to eliminate obvious abuses and to conform the legislative scheme to the realities of today's markets and technologies.

17. Diligent consideration should be given to the elimination of "greenmail" and to a rule that would require full financing of tender offers before they are made.

18. Steps must be taken to assure that disclosures of material corporate information reach the public more quickly and effectively.

(a) Companies that file late or submit incomplete or inaccurate filings should be brought to task by the Commission.

(b) Congress should consider legislation to accelerate disclosure of market sensitive information, including: (1) filing of section 13(D) reports of substantial stock acquisition within 2 days of their acquisition rather than 10 days; and (2) acceleration of 16(A) reports of stock transactions by corporate insiders from 10 days after the close of the month to 2 business days after the transaction.

19. Legislation should be considered that clarifies and strengthens the definition of a "group" so as to assure appropriate disclosure under section 13(D) of concerted or coordinated activities relating to significant acquisitions of stock in publicly-held companies.

Responses of Raymond A. Mason
(Chairman of the Board and Chief Executive Officer
of Legg Mason Wood Walker, Incorporated)
to the Outline of Some of the Recommendations Made at the
Securities Subcommittee Hearing Held on February 24, 1987*

1. I agree that the EDGAR System should be adequately funded.

2. My position on the development by the Commission of a "vastly improved" surveillance capability for all U.S. securities markets would depend upon the specific details of the proposal, including costs (both monetary and paper work) and effect on the efficient functioning of the markets. Generally, it should be necessary for the Commission to step in only when the exchanges and the NASD are not able to properly perform appropriate functions.

3. Cease and desist powers for the Commission may be appropriate in certain cases. However, I do not believe that, as a general matter, there should be a broad substitution of Commission power for the judicial enforcement procedures now required.

4. I do not believe that the Commission should be given authority to impose fines.

5. As a general proposition, I would be inclined t support a careful clarification of the Commission's injunctiv. authority, including the spelling out of specific equitable remedies, although I would be concerned if the explicit addition of remedies did not include a requirement that the Commission first show an underlying need for immediate injunctive relief.

6. I support this clarification of the Commission's disciplinary authority over broker-dealers.

7. I support formal cooperative ventures between the United States and foreign governments to ensure mutual evidentiary assistance in cases of national importance. I do not express any position at this time as to whether legislation is necessary to encourage such formal cooperative ventures.

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* The numbers below correspond to the numbers of the recommendations included in the outline prepared by the Subcommittee staff. A copy of the outline is attached. No position is expressed at this time with respect to numbers which have been omitted.

8. I agree that there should be authorization to require procedures similar to section 17(j), although care should be taken in evaluating the extent to which such procedures would be imposed.

9. I would support a carefully-drawn expansion of the Commission's rule-making authority to enable the Commission to cope with such changing investment products and practices as financial futures and the provisions of discount brokerage services by depository institutions.

10. I do not know that a thorough overhaul of our securities laws and regulations is either necessary or appropriate at this time. However, I would have no objection to the organization of an independent committee under the jurisdiction of Congress, with balanced representation including all segments of the securities industry, with a carefully crafted charter to investigate and make proposals with respect to generally recognized problem areas.

11. I would support the elimination of unnecessary restrictions imposed by the exchanges on the listings of securities of foreign issuers, provided that careful attention be paid to the maintenance of a level playing field in which there are no advantages accorded to the trading of securities of foreign as opposed to domestic issuers.

12. I think it makes good sense for Congress to attempt to establish principles for allocating regulatory responsibilities along functional lines.

14. I do not believe that sanctions should be expanded until there has been some experience with the effect of the Commission's previously expanded enforcement focus in this area, and with the expanded focus on the responsibilities of independent auditors.

15. I agree with the general proposition that the sanction of a bar from corporate office should be available in egregious cases of fraudulent financial reporting so long as the rules are clearly understood (with emphasis on volitional activity and on the availability of a defense for reliance upon professionals).

16. I would support a careful redrafting of present tender offer rules to eliminate obvious abuses and to ensure that the rules conform to the realities of today's markets and technologies.

17. I agree that diligent consideration should be given to the elimination of "greenmail".

18. (a) I agree that companies that file late or submit incomplete or inaccurate filings to the Commission should be brought to task but, obviously, any penalty should properly fit the offense; harsh penalties for technical offenses which do not affect the markets would not be acceptable.

(b) I would support a reduction in the present 10-day requirement for the filing of Section 13(d) and 16(a) reports, although in the case of Section 16(a) I would use the date of certified mailing rather than the date of receipt by the Commission as the date on which the report is considered to have been filed.

19. I would support either legislation or rulemaking to clarify the definition of a "group" for purposes of appropriate disclosure under Section 13(d).

Senator D'Amato's Questions to
Alvin V. Shoemaker
Oversight Hearing on Securities Industry and
Securities and Exchange Commission
February 24, 1987

1. Some of my colleagues have urged that we must enact tender offer reform legislation designed to curb takeover activity in an effort to curtail insider trading activity. Should any amendments to the Williams Act that we consider be influenced by a desire to eliminate insider trading or are these (insider trading and tender offer reforms) separate issues which should be addressed by separate legislative proposals?

A. Insider trading and tender offer reform are distinct issues which should be dealt with separately. The misuse of confidential information unfortunately occurs in connection with friendly merger discussions, plans for corporate reorganizations, and many other situations which do not involve takeovers. Indeed, the opportunity for misuse in the friendly merger situation is far greater than in the unsolicited tender offer. Far more people must be entrusted with the information in order to carry on negotiations. Yet no one has suggested that friendly merger discussions should be restricted in order to deal with insider trading. In short, preventing insider trading and regulating hostile takeover attempts should not be confused.

2. Some of our colleagues have argued that tougher sanctions are needed to deter insider trading. Are more penalties needed or are more policemen to enforce the existing laws prohibiting insider trading sufficient? Do you think that the sanctions imposed on Dennis Levine were adequate to send a message to Wall Street (2 years in jail, $350,000 in criminal penalties in addition to the millions of dollars in civil penalties).

A. The principal problem in the area of insider trading has been the belief that the risk of detection is slight. Unfortunately, because of the SEC's lack of resources, this belief has had a basis in fact. The answer therefore is to give the SEC more resources to investigate possible insider trading situations. I also believe that Congress should review the penalties levied for insider trading to ensure that they emphasize that our society views the crime of insider trading as a serious offense.

3. What legislation would you recommend to provide added deterrence? Should we provide a statutory definition of insider trading to provide greater guidance to participants in the securities markets? (England, France and, by this summer, Switzerland have or will have statutes on the books that define insider trading.)

A. I support the effort that is currently underway to determine if insider trading needs to be defined by law. Defining insider trading properly is a difficult task and expert help will be required.

4. How can we effectively deter insider trading when transactions can be executed from off-shore locations where insider trading is not illegal? To curtail insider trading, shouldn't we attempt to enter into treaties with foreign countries which require reciprocity or a more uniform policing of securities fraud in the U.S. and international markets?

A. There appears to be a need for treaties or agreements between nations with respect to policing fraud in the United States and international markets. However, this is only one of the difficult challenges presented by the increased globalization of the securities markets. The United States markets are beginning to face stiff competition from other markets. We must make greater efforts to integrate the United States securities markets with other world markets, or face the loss of business. Outmoded and unnecessary restrictions on transactions in our markets should be eliminated. Treaties and agreements should focus on these larger and perhaps more important problems.

5. Since the enactment of the Federal Securities laws in the 1930's, self-regulation has been a basic tenet underlying securities regulation. Have the recent insider trading scandals revealed that most firms pay only lip service to self-regulation? What steps can individual law firms, securities firms and corporations take to prevent insider trading? Have these firms been derelict in their duties of sending a clear message to their employees that insider trading will not be condoned by the firm?

A. While I do not agree that securities firms have paid only lip service to self-regulation, it is obvious that more vigilance must be given to the control of confidential information. Securities firms, law firms, and corporations all should re-examine their policies and procedures for con-

trolling confidential information to determine how they can be improved. This process, which has already commenced on a large scale, should result in more effective self-regulation in this area.

5A. In his testimony, Milton Cohen states that self-regulation, in essence, begins with the individual firms. Have the firms failed to adequately self-regulate their trading activities as Mr. Cohen has suggested? What steps have your firms taken to avoid the particular abuses regarding proprietary trading that Mr. Cohen refers to on page 23 of his testimony?

A. I cannot speak for other firms and the adequacy of their internal compliance systems. About a year ago, First Boston, with the assistance of outside counsel, conducted a comprehensive review of our compliance systems, and action has been taken to improve and strengthen these systems. I cannot disclose the details of the system because to do so would provide a blueprint for circumvention and impair its effectiveness. Briefly, the first part of the system is to monitor our employees' trading activities and to make it clear that insider trading and the accompanying damage to the firm's reputation and the integrity of the market is simply not tolerated. This message is imparted through employee training programs and through the very existence of internal controls. Employees are required to do their trading through in-house accounts. In addition, the firm's knowledge of its employees and their trading patterns is part of the monitoring system. All trades are reviewed the next day and checked against "watch" and "restricted" lists of companies from which the firm has received inside information.

The second part of the internal surveillance system is the so-called "Chinese Wall" which separates underwriting or investment banking activities from the firm's trading activities in order to restrict the flow of "inside" information to sales, trading and research personnel. The Wall is used rather than a flat prohibition on trading once "inside" information is received because the very act of stopping trading would itself tip the market. These activities are separated physically as well as by procedure. Inside information is transferred between these two departments only on a "need to know" basis, i.e., only to the extent necessary to perform the investment banking or corporate finance services for which the client provided us the confidential information. Transfer of information can

only be made at the senior level, and any employee brought "through" the Chinese Wall, of course, becomes subject to restrictions on trading on and disclosure of such information. The transfer of inside information is coordinated through our legal department. The legal department keeps a "watch" list of companies upon which First Boston possesses "insider" information and uses the list to monitor trading in the company's securities to assure that there is no trading which is based on the "inside" information. The "restricted" list restricts sales, trading, and research activities with respect to securities of those companies on the list. These lists are designed to prevent or limit customer solicitation, research and trading when First Boston has "insider" information which is not contained within the Chinese Wall. The legal department also tests the Chinese Wall to make sure it is effective when an important transaction is taking place. Finally, our internal audit department has been given a mandate to audit the system on an ongoing basis.

6. Since it appears that self-regulation with regard to insider trading has become somewhat lackadaisical, shouldn't a civil sanction be imposed upon a firm if one of its employees has been found guilty of insider trading and the firm knew or should have known of these illegal activities?

A. I am not sure that it is necessary to impose this kind of liability because there is already ample incentive for firms to prevent illegal conduct by their employees. If a firm has been derelict in carrying out its duty to supervise an employee who violates the federal securities laws, it can be sanctioned by the SEC and the SROs. The potential sanctions include limitations on activities, a suspension and ultimately disbarment from the securities industry for any firm or supervisory employee who fails to meet the duty of supervision.

7. Dennis Block, a prominent member of the securities bar, has suggested that insider trading would be less prevalent if a securities firm is prevented from engaging in arbitrage activity where it is also acting as an investment banker to a company involved in a takeover. What do you think about such a prohibition?

A. I strongly disagree with this suggestion. Such a prohibition would be, in my judgment, a serious mistake which can increase the potential for insider trading. I believe that the appropriate responses to the insider trading problem are

to enhance the Chinese Wall and restricted list procedures at multi-service firms and to increase the risk of detection by providing more funding for SEC enforcement. The prohibition on arbitrage activity is an extreme and unwise reaction and, in fact, will likely do more harm than good.

8. The Williams Act, enacted in 1968, was designed to protect investors by ensuring that both bidders and targets play by a federally mandated set of rules during contests for corporate control. In light of some of the perceived "deficiencies" in the Williams Act, do you think that the Act needs a complete overhaul or more of a fine tuning? What specific modifications would you suggest we make without tipping the balance in favor of bidders or targets-- a balance that the authors of the Williams Act sought to create and preserve?

A. I believe that a "fine tuning" of the Williams Act is the proper course of action. We have recommended, for example, the elimination of greenmail, Section 13(d) disclosure before crossing the 5 percent threshold, and the imposition of substantial sanctions for those who knowingly violate Section 13(d). These changes will reduce the opportunities for abuse which currently exist without entrenching incompetent or unimaginative management.

9. Much SEC analysis and media coverage has been given to the New York Stock Exchange's (NYSE) application to the SEC which would enable the NYSE to amend its one share/one vote listing standards. Do you think that the NYSE listed stocks should be allowed to issue shares with disparate voting rights? Does a movement away from the one share/one vote standard mark the death knell for the concept of "corporate democracy?" Should the management of a company that issues stock with disparate voting rights be restricted or precluded from owning stock with full voting privileges in order to avoid management's ability to entrench itself? For the purposes of voting on issues related to changes in corporate control, should the one share/one vote principle apply to companies issuing stock that have disparate voting rights?

A. The NASD and the NYSE appear to have reached a compromise position on this matter so it may be premature to fashion a legislative solution at this time. However, it may be necessary to provide some exemptive relief so that foreign equities can more easily be listed for trading on our securities exchanges.

10. Do arbitrageurs play any useful role in corporate takeover contests? Should we consider legislation that essentially eliminates arbitrage activity in battles for corporate control? How could we legislatively limit the arbitrageurs role?

A. Arbitrageurs do provide a useful function by providing a market for the ordinary investor who does not want to gamble on the outcome of a publicly-announced tender offer. The arbitrageurs assume the risk that the offer will fail and that the market price of the stock will drop to its pre-announcement level. I do not believe that it is wise to eliminate this healthy activity. However, we must take action to ensure that arbitrageurs like other investors do not trade illegally on inside information.

11. In his statement, Milton Cohen is critical of the concept of "bridge financing." What useful purposes does bridge financing serve and should there be any regulation of it? What are the abuses that can result from too great a reliance on bridge financing?

A. Bridge financing provides an alternative and a supplement to the use of high-yield bonds, bank financing, and the other means of raising the capital necessary for a tender offer. Unlike the situation where a bank loans depositors' insured funds to its investment banking client, there is no conflict of interest involved where a securities firm loans its own money to its client. Similarly, the ability of an investment banker to offer objective advice is not compromised but rather enhanced by having a stake in the outcome since both the client and the firm have the same interest. A securities firm, unlike a bank, does not owe a conflicting duty to its depositors or trust customers which may pressure it to take excessive risks or make imprudent decisions in its investment banking activities. Thus far, I am unaware of any abuses of this financing technique that would establish a reason to regulate bridge financing.

12. The increased internationalization of the securities market has raised concerns about the ability of the U.S. capital market to remain competitive globally. In his statement, Mr. Shoemaker notes that steps must be taken to ensure that the U.S. market not become outmoded due to regulatory impediments. In the face of increasingly internationalized markets, how can we hope to impose the regulatory standards embodied in our federal securities laws on foreign markets?

How can foreign markets be expected to adopt our investor protection and disclosure standards when their recent growth is due largely to the fact that their regulatory standards are lower than ours?

A. I think we need to examine those regulations which may be impediments to the internationalization of capital markets and eliminate those which are not necessary to investor protection. The integrity of the capital markets, both domestic and international, is based on investor confidence which in turn depends on appropriate regulation. This premise should underly the coordinated effort which I said in my testimony is needed to assure that "regulatory arbitrage" or forum shopping does not occur. The recent agreement between British and U.K. bank regulators on risk-based capitalization is a good example of the type of efforts which should be encouraged.

13. On February 19, 1987, the NYSE issued a Special Membership Bulletin in which the Exchange "determined that additional resources must be dedicated to meeting our regulatory responsibilities." I am including a copy of this Bulletin for your convenience. Do you feel that the NYSE recommendations are adequate or must Self-Regulatory Organizations take on even more responsibilities than those described in the Bulletin?

A. I feel that the NYSE recommendations are an important part of the ongoing improvements to be made by the industry and the SRO's. But no matter how much improvement is made in self-regulation there will always be the need for a vigorous and omnipresent SEC as the best deterrent to malfeasance.

14. In the testimony of Robert Rittereiser (see p. 7) he states that the development of derivative products such as options and futures when combined with program trading creates a problem of extraordinary market volatility during those 4 Fridays of the year with "triple witching hours."

(a) Is this volatility only limited to 4 triple witching hours each year? (The 114 point swing in the market on January 23, 1987 was not on a triple witching hour Friday; the 120 point drop on September 11 an 12 was not on a triple witching hour Friday.)

(b) NYSE Chairman John Phelan recently expressed his concern that a failure to curtail the volatility of a program trade driven stock market could lead to a 1929-

style market crash. Do you agree with Phelan's assessment and how could such a crash be triggered by program trading? How likely is the occurrence of such a market calamity?

(c) What specific regulation of program trading activity is required?

A. We are unaware of any credible evidence linking market volatility with program trading. In terms of the position attributed to John Phelan that program trading could trigger a 1929-style market crash, we know of no information or empirical evidence to support such a conclusion. We do support the efforts of the New York Stock Exchange and other exchanges to reduce the uncertainty which can occur on the four Friday's a year when stock index and future options expire, the so-called "triple witching hour," by disclosure requirements.

15. Some critics of program trading suggest that it is nothing more that a sophisticated form of market manipulation. How do you respond to such criticisms when it appears that a firm such as Salomon Brothers could turn the market around in a short time based on its own buy orders? (On December 19, 1986, the market was down between 5-10 points during the last half hour of trading. Salomon initiated a buy program and turned the market around by ordering the purchase of $2 billion worth of equities at the close. The market finished up 16.03 points with trading of 118.5 million shares in the final hour.)

16. It appears that the investor who has the potential for downsider risk in a market dominated by program trading is the small investor. Does program trading have the effect of locking the small investor out of the market? Should small investors avoid trading on those triple witching hour Fridays?

17. It appears that program trading is triggered by trends in the option and futures index rather than by more traditional methods of analysis regarding a buy or sell recommendations. What do you perceive as the effects of this major shift from trading stocks, not on fundamentals such as a company's earnings and dividends, but on technical computer strategies that can drastically swing the market in minutes?

18. How much of your firm's capital is committed to program trading? Are borrowed funds used to engage in program trading?

A. The design of our record-keeping and reporting systems do not permit us to extract the type of information which you have requested.

19. If substantial arbitrage programs are unwound in the same direction late on an expiration day, an extreme imbalance of orders may result that sends the market plummeting. How can exchange specialists attempt to make an orderly market when faced with such imbalances. What's being done to handle a large unwinding of exchange positions in the market? How successful was the plan agreed on by the NYSE and the SEC where so-called market on close orders in certain stocks were required to be submitted at 3:30 p.m. rather than 4:00 p.m. when the market actually closed?

A. (Questions 15, 16, 17, 19)

Part of the confusion which appears to be reflected in these questions may be the result of the failure to distinguish between "portfolio trading," which is a systematic purchase or sale of entire portfolio of stocks, and "index arbitrage," which is the purchase or sale of one asset and the simultaneous sale of an equivalent asset in different markets to profit from unequal prices. The trades associated with both transactions are often executed by computer and, hence, these distinct market activities are often lumped under the heading of "program trading." This can result in a great deal of mythology about what is actually occurring in the market, and whether or not it is good or bad. Both methods of program trading, "portfolio trading" and "index arbitrage," have been estimated to account for approximately 10%-15% of equity transactions, with roughly a 50/50 split. Both trading strategies have legitimate trading objectives and serve to increase the efficiency of the markets.

As stated above, regulation of the "triple witching hour" phenomenon, via greater disclosure, can be effective and has the support of First Boston.

In terms of the point that trading in options and future indexes is somehow in conflict with "traditional methods" of evaluating the fundamental values of stocks, this argument seems to ignore the reality that all of these derivative

products are based, in the final analysis, on the value of the underlying asset -- in this case, the actual stocks involved. Accordingly, the profit or loss in both "portfolio trading" and "index arbitrage" ultimately is determined by the value of the underlying stocks.

Outline of Some of the Recommendations
Made at the Securities Subcommittee Hearing
February 24, 1987 and the Responses of
Alvin V. Shoemaker

1. The EDGAR System of the Securities and Exchange Commission ("Commission") deserves the full support of the Congress and should be adequately funded.

A. I agree.

2. The Commission should also be developing a vastly improved surveillance capability for all U.S. securities markets.

A. I agree. The Commission needs improved technological resources.

3. The Commission should be given cease-and desist powers.

A. I have testified in favor of a strong and active Commission with sufficient enforcement powers to provide an effective deterrent to wrongdoing. To that end, I would support any enforcement powers which the Commission requests and which the Commission believes it needs to perform its functions. As the enforcement agency for our securities laws, it is best able to determine what powers are needed and which powers serve as the best deterrents.

4. The Commission should be given the authority to impose fines as a general enforcement tool.

A. See my response to Recommendation No. 3.

5. The Commission's traditional injunctive authority should be clarified to confirm the SEC's authority to seek a host of equitable remedies, such as the disgorgement of ill-gotten gains, the appointment of receivers, and the requirement that institutional violators of the federal securities laws be directed to implement prophylactic measures to ensure against a repetition of the violative conduct.

A. See my response to Recommendation No. 3.

6. The Commission's disciplinary authority over broker-dealers should be clarified, so that there will be no dispute concerning the agency's power to suspend errant professionals for a period exceeding twelve months but less than a lifetime bar.

A. See my response to Recommendation No. 3.

7. Legislation should be enacted to encourage foreign governments to enter into formal cooperative ventures with U.S. law enforcement authorities, similar to the memoranda of understanding between the United Kingdom and the United States and between Switzerland and the United States, to ensure mutual evidentiary assistance in cases of national importance.

A. I agree that foreign governments should be encouraged to enter into formal cooperative ventures with U.S. law enforcement authorities and applaud the steps that have been taken thus far. To the extent that legislation can be drafted to further encourage such efforts, I would agree with such a recommendation.

8. Legislation should be enacted to authorize the SEC to require firm's professionals who are privy to market-sensitive, nonpublic information to adopt meaningful guidelines, much as section 17(j) of the Investment Company Act of 1940 requires portfolio managers of investment companies to adhere to standards adopted by their own firms.

A. I support the concept of legislation authorizing the SEC to require firms to adopt standards and procedures for employees who are entrusted with market-sensitive information. However, consistent with the concept of self-regulation which underlies the federal securities laws, firms should be given a wide degree of freedom in designing procedures which are meaningful given their particular structure and operating procedures. The SEC's role should be limited to keeping a vigorous and watchful eye on the industry's efforts to fashion and enforce meaningful standards for employees.

9. The Commission's rulemaking authority should be expanded, to enable the agency to cope with changing investment products -- such as financial futures - and changing securities services -- such as the provision of discount brokerage services by depository institutions.

A. I agree that the Commission's rulemaking authority should be expanded to address changing investment products and securities services. A prime example of a significant gap in the securities regulatory scheme is the unregulated securities activities of banks. I noted this in my written testimony and would reiterate that this severe deficiency in

the securities laws must be corrected, beginning with Commission authority to regulate banks or bank subsidiaries which engage in broker-dealer activities.

10. A study should be conducted by an independent committee commissioned by, and under the jurisdiction of Congress, with a view toward recommendations for new legislation and improved regulations.

A. Such a study would be most helpful to the development of a balanced package of any new legislation and improved regulations which may be deemed to be necessary.

11. Exchanges should review their listing requirements with a view to eliminating unnecessary restrictions on foreign listings.

A. As I said in my written statement, the U.S. should not impose regulatory impediments to the free flow of capital in the international market. To the extent that a regulatory requirement is not necessary to investor protection and imposes an unnecessary burden, it should be eliminated. However, I would not condone any lessening of our standards simply to attract foreign capital if such an action threatens the integrity of our market.

12. Congress should establish principles for allocating regulatory responsibilities along functional lines.

A. This recommendation reflects the same concerns which I addressed in response to Recommendation No. 9, that bank securities activities are not regulated. I think that they should be regulated in order to protect investors and to preserve the integrity of the market.

13. The Commission should eliminate the Short-Sale Rule which does not exist on the London and Tokyo Exchanges.

A. See my response to Recommendation No. 11.

14. The Commission's sanctions for those who violate the law by their involvement in fraudulent financial reporting are not adequate and should be significantly increased.

A. See my response to Recommendation No. 3.

15. Barring from corporate office those who cause, aid and abet, or participate in fraudulent financial reporting is an appropriate sanction, and one which ought to be regularly

considered by the Commission in enforcement proceedings involving fraudulent financial reporting.

A. See my response to Recommendation No. 3.

16. The current legislation regarding tender offers and related corporate transactions should be overhauled to eliminate obvious abuses and to conform the legislative scheme to the realities of today's markets and technologies.

17. Diligent considerations should be given to the elimination of "greenmail" and to a rule that would require full financing of tender offers before they are made.

18. Steps must be taken to assure that disclosures of material corporate information reach the public more quickly and effectively.

(a) Companies that file late or submit incomplete or inaccurate filings should be brought to task by the Commission.

(b) Congress should consider legislation to accelerate disclosure of market sensitive information, including: (1) filing of section 13(D) reports of substantial stock acquisition within 2 days of their acquisition rather than 10 days; and (2) acceleration of 16(a) reports of stock transactions by corporate insiders from 10 days after the close of the month to 2 business days after the transaction.

19. Legislation should be considered that clarifies and strengthens the definition of a "group" so as to assure appropriate disclosure under section 13(d) of concerted or coordinated activities relating to significant acquisitions of stock in publicly-held companies.

A. Recommendations 16, 17, 18, and 19. There are some changes in the takeover area which should be made. Greenmail should be eliminated. The Section 13(d) window should be closed by requiring the filing of a notice prior to reaching 5 percent. Sanctions should be imposed on any person or group which fails to file a 13D notice in a timely fashion or which files a statement which is false or misleading as to investment intent. Finally, recent revelations about "warehousing" indicate that Congress should consider a stronger definition of the concept of a "group" under Section 13(d).

However, the case for a major overhaul of the Williams Act has not been made. The basic premise of the Act -- that investors should be protected in ways which do not tip the scales in favor of incumbent managers of a publicly-owned company or persons attempting to purchase control -- remains as valid today as when Congress created the Act. Maintaining a healthy market for corporate control is in our national interest. The elimination of greenmail, the requirement of earlier Section 13(d) disclosure, and the imposition of sanctions for the failure to make proper 13(d) disclosure will help cure the abuses which are currently plaguing the takeover area without tipping the balance in favor of either side.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM
MILTON H. COHEN

Q.1. Some of my colleagues have urged that we must enact tender offer reform legislation designed to curb takeover activity in an effort to curtail insider trading activity. Should any amendments to the Williams Act that we consider be influenced by a desire to eliminate insider trading or are these (insider trading and tender offer reforms) separate issues which should be addressed by separate legislative proposals?

Answer to - Q.1 The areas of tender offer reform and insider trading reform overlap very materially but not totally. Thus, each needs separate attention, but with especially strong focus on the overlapping territory.

Q.2. Some of our colleagues have argued that tougher sanctions are needed to deter insider trading. Are more penalties needed or are more policemen to enforce the existing laws prohibiting insider trading sufficient? Do you think that the sanctions imposed on Dennis Levine were adequate to send a message to Wall Street (2 years in jail, $350,000 in criminal penalties in addition to the millions of dollars in civil penalties)?

Answer to Q.2 I think the Commission and the courts have adequate power to impose tough sanctions, and prosecutors (including the SEC's Enforcement Division) appear to be seeking tough sanctions. I believe that the concept of "more policemen" should be expanded to "more effective enforcement machinery," under which I would include not only more personnel but also stronger automation capability and maximum cooperation among regulatory agencies.

I believe the sanctions imposed on Levine, in the circumstances, were adequate to send a message to Wall Street.

Q.3. What legislation would you recommend to provide added deterrence? Should we provide a statutory definition of insider trading to provide greater guidance to participants in the securities markets? (England, France and, by this summer, Switzerland have or will have statutes on the books that define insider trading.)

Answer to Q.3 I believe that it would be desirable to have a statutory definition of insider trading and that efforts to draft such a definition should be encouraged. However, the task will not be easy because, among other reasons, an overly specific definition may be worse than none at all.

Q.4. How can we effectively deter insider trading when transactions can be executed from off-shore locations where insider trading is not illegal? To curtail insider trading, shouldn't we attempt to enter into treaties with foreign countries which require reciprocity or a more uniform policing of securities fraud in the U.S. and international markets?

Answer to Q.4 As markets become more internationalized there doubtless will be need for treaties of various kinds to cover matters of business conduct and misconduct (as well as operational matters) that may be international in scope. However, major reliance may have to be on broker-dealer firms' controls over the conduct of their own personnel, including foreign conduct on the part of domestic personnel as well as conduct of personnel stationed abroad. In turn, the self-regulatory organizations and/or the Commission may need to promulgate standards with regard to broker-dealer firms' codes of conduct as well as their surveillance and enforcement measures.

Q.5. Since the enactment of the Federal Securities laws in the 1930's, self-regulation has been a basic tenet underlying securities regulation. Have the recent insider trading scandals revealed that most firms pay only lip service to self-regulation? What steps can the individual law firms, securities firms and corporations take to prevent insider trading? Have these firms been derelict in their duties of sending a clear message to their employees that insider trading will not be condoned by the firm?

Answer to Q.5 I believe that self-regulation, with governmental oversight, should continue to be given maximum scope wherever a regulatory need can be met satisfactorily. I do not believe there is reason to conclude that "most firms pay only lip service" to self-regulation. However, it seems clear that self-regulation is operating unevenly, and at least in some firms inadequately, and that possibilities for tightening the self-regulatory and oversight mechanisms should be seriously considered at this time.

I believe that every securities firm (and law firm doing a corporate and securities business) should be expected to have a strong set of rules and standards, and a strong system of enforcing those rules and standards, with regard to using non-public corporate or market information for private benefit. The message that violations will not be condoned, and may be an automatic ground for termination of employment, ought to be emphatically and repeatedly conveyed to employees.

Q.6. Since it appears that self-regulation with regard to insider trading has become somewhat lackadaisical, shouldn't a civil sanction be imposed upon a firm if one of its employees has been found guilty of insider trading and the firm knew or should have known of these illegal activities?

Answer to Q.6 While "somewhat lackadaisical" apparently fits many firms, applying these words to the industry generally may not be justified. In any event, it appears that existing controls over insider trading need to be tightened. This should include imposing appropriate sanctions on firms that know or clearly could and should have known of employees' illegal activity.

Q.7. Dennis Block, a prominent member of the securities bar, has suggested that insider trading would be less prevalent if a securities firm be prevented from engaging in arbitrage activity where it is also acting as an investment banker to a company involved in a takeover. What do you think about such a prohibition?

Answer to Q.7 I would be inclined to favor such a prohibition. However, the dual activity of arbitraging and acting as an investment banker to a company involved in a takeover is probably only one of many situations where inside information is regularly generated and may be misused by a firm's personnel (or the firm itself) in the absence of a truly effective Chinese Wall (as to which I would be very skeptical) or an actual prohibition against engaging in both activities during critical periods.

Q.8. The Williams Act, enacted in 1968, was designed to protect investors by ensuring that both bidders and targets play by a federally mandated set of rules during contests for corporate control. In light of some of the perceived "deficiencies" in the Williams Act, do you think that the Act needs a complete overhaul or more of a fine tuning? What specific modifications would you suggest we make without tipping the balance in favor of bidders or targets -- a balance that the authors of the Williams Act sought to create and preserve?

Answer to Q.8 I believe that serious consideration should be given to amending the Williams Act, probably less than "a complete overhaul" but more than "fine tuning." With regard to the related subject of proxy solicitations, the original Securities Exchange Act of 1934 gave the Commission broad power to prescribe rules and regulations "necessary or appropriate in the public interest or for the protection of investors." The Williams Act also gave rule-making authority to the Commission, but more narrowly: to prevent "fraudulent, deceptive or manipulative acts and practices."

There has been enough experience with some acts or practices that have evolved (e.g., "greenmail" (as appropriately defined), two-tier front-end-loaded offers, and offers made without assured financing) so that they probably could and should be dealt with by specific statutory amendments. But at the same time serious consideration should be given to broadening the Commission's rule-making authority, on the model of the proxy solicitation provisions, to cover tactics that may be grossly unfair or otherwise contrary to the public interest or the interest of investors even though not fitting within the rubric of "fraudulent, deceptive or manipulative."

Q.9. Much SEC analysis and media coverage has been given to the New York Stock Exchange's (NYSE) application to the SEC which would enable the NYSE to amend its one share/one vote listing standards. Do you think that the NYSE listed stocks should be allowed to issue shares with disparate voting rights? Does a movement away from the one share/one vote standard mark the death knell for the concept of "corporate democracy?" Should the management of a company that issues stock with disparate voting rights be restricted or precluded from owning stock with full voting privileges in order to avoid management's ability to entrench itself? For the purposes of voting on issues related to changes in corporate control, should the one share/one vote principle apply to companies issuing stock that have disparate voting rights?

Answer to Q.9 In general, I believe that any further movement away from one share/one vote listing standards would be unfortunate. I hope that the ongoing effort to raise the listing standards of other markets rather than lowering the listing standards of the NYSE will succeed, so that this important matter will no longer be the subject of competition among markets and inevitable "race to the bottom."

Q.10. Do arbitrageurs play any useful role in corporate takeover contests? Should we consider legislation that essentially eliminates arbitrage activity in battles for corporate control? How could we legislatively limit the arbitrageurs role?

Answer to Q.10 Arbitrage probably serves a useful function, but only if it is engaged in independently and without any form of cooperation with involved parties or their investment bankers or lawyers, or any use of non-public corporate or market information. I am not able at this time to be more specific as to appropriate reforms, but I believe the topic needs prompt and thorough exploration with a view to appropriate legislation or regulatory measures.

Q.11/12. **The increased internationalization of the securities market has raised concerns about the ability of the U.S. capital market to remain competitive globally. In his statement, Mr. Shoemaker notes that steps must be taken to ensure that the U.S. market not become outmoded due to regulatory impediments. In the face of increasingly internationalized markets, how can we hope to impose the regulatory standards embodied in our federal securities laws on foreign markets? How can foreign markets be expected to adopt our investor protection and disclosure when their recent growth is due largely to the fact that their regulatory standards are lower than ours?**

Answer to Q.12 The task of accommodating the U.S. regulatory system to the internationalization phenomenon is very important but very difficult. I do not feel competent to make any recommendations at this time, other than that the topic needs thorough, prompt and continuing exploration. While some relaxation of some U.S. requirements may be part of the ultimate answer, I believe it would be a serious mistake to assume that this should be a one-way street, in the sense that our standards should be brought down to the level of standards elsewhere without seeking to bring the latter closer to ours. I have the impression (which may or may not be accurate) that there may be more inclination on the part of foreign authorities to move in our direction, and therefore the outlook is less gloomy, than the question implies. At some point, of course, lowering of U.S. standards must be rejected even at the cost of competitive disadvantage.

Q.13. **On February 19, 1987, the NYSE issued a Special Membership Bulletin in which the Exchange "determined that additional resources must be dedicated to meeting our regulatory responsibilities." A copy of this Bulletin is enclosed. Do you feel that the NYSE recommendations are adequate or must Self-Regulatory Organizations take on even more responsibilities than those described in the Bulletin?**

Answer to Q.13 About the time the NYSE issued its Special Membership Bulletin it also initiated its own Study of Self-Regulation and appointed an outside advisory committee. I am a member of that committee and I hope that our work will help to strengthen the Exchange's self-regulatory program beyond the contents of the Special Membership Bulletin.

Q.14. In the testimony of Robert Rittereiser (see p. 7) he states that the development of derivative products such as options and futures when combined with program trading creates a problem of extraordinary market volatility during those 4 Fridays of the year with "triple witching hours."

(a) Is this volatility only limited to 4 triple witching hours each year? (The 114 point swing in the market on January 23, 1987 was not on a triple witching hour Friday; the 120 point drop on September 11 and 12 was not on a triple witching hour Friday.)

(b) NYSE Chairman John Phelan recently expressed his concern that a failure to curtail the volatility of a program trade driven stock market could lead to a 1929-style market crash. Do you agree with Phelan's assessment and how could such a crash be triggered by program trading? How likely is the occurrence of such a market calamity?

(c) What specific regulation of program trading activity is required?

Answer to Q.14 Program trading is now receiving serious attention on the part of the Commission, the NYSE and others. It is clear that program trading extends far beyond "triple witching hours" and that it contributes in some degree to volatility. I have no personal means of knowing whether there is any risk of a market calamity, but I share the view that this and related questions must be thoroughly explored. Good beginnings appear to have been made at the Commission and the NYSE.

Q.15. Some critics of program trading suggest that it is nothing more than a sophisticated form of market manipulation. How do you respond to such criticisms when it appears that a firm such as Salomon Brothers could turn the market around in a short time based on its own buy orders? (On December 19, 1986, the market was down between 5-10 points during the last half hour of trading. Salomon initiated a buy program and turned the market around by ordering the purchase of $2 billion worth of equities at the close. The market finished up 16.03 points with trading of 118.5 million shares in the final hour.)

Answer to Q.15 To the extent of my present knowledge, program trading appears to be both more and less than "a sophisticated form of market manipulation." "Manipulation" implies an unlawful intent to affect prices artificially, whereas program trading is an investment strategy the success of which does not depend on any such intent. This does not mean, however, that program trading may not have unacceptable or abusive consequences. The subject is already being very actively studied and the ongoing studies will probably lead to suggestions for appropriate controls or restrictions. Presumably such controls and restrictions would prevent a repetition of Salomon Bros.' activity in the last half hour of trading on December 19, 1986.

Q.16. It appears that the investor who has the potential for downsider risk in a market dominated by program trading is the small investor. Does program trading have the effect of locking the small investor out of the market? Should small investors avoid trading on those triple witching hour Fridays?

Answer to Q.16 As brought out in a recent address by SEC Commissioner Grundfest, program trading -- which he considers a desirable development -- cannot be engaged in by the small investor and may be said to put the latter at a disadvantage in relation to institutional investors. Unless ongoing studies show the need, and suggest the form, of major changes or limitations in the kind of program trading that now takes place, perhaps the best means of protecting small investors is along educational lines: to seek to make them aware that an institutionalized, automated market may be more volatile than formerly was the norm, and that if they choose to invest individually as distinguished from indirectly, as participants in institutions, they must pay more attention to longer-term price trends than to very short-term price movements.

Q.17. It appears that program trading is triggered by trends in the options and futures index rather than by more traditional methods of analysis regarding a buy or sell recommendation. What do you perceive as the effects of this major shift from trading stocks, not on fundamentals such as a company's earnings and dividends, but on technical computer strategies that can drastically swing the market in minutes?

Answer to Q.17 For many years and for many reasons there appears to have been a trend toward deemphasizing "fundamentals" and emphasizing "technical factors" in investment and trading. Increasing institutionalization, advancing automation, and growing acceptance of the "random walk" theory of stock allocation have strengthened and accelerated this trend. It appears to me that the trend is inevitable and irreversible and the regulatory system must be adapted to it, insofar as necessary or appropriate, so as reasonably to meet the statutory objectives of protecting investors and the public interest in the changed environment.

Q.18. How much of your firm's capital is committed to program trading? Are borrowed funds used to engage in program trading?

Answer to Q.18 Not applicable, because I am a lawyer and not in the securities business.

Q.19. If substantial arbitrage programs are unwound in the same direction late on an expiration day, an extreme imbalance of orders may result that sends the market plummeting. How can exchange specialists attempt to make an orderly market when faced with such imbalances. What's being done to handle a large unwinding of exchange positions in the market? How successful was the plan agreed on by the NYSE and the SEC where so-called market on close orders in certain stocks were required to be submitted at 3:30 p.m. rather than 4:00 p.m. when the market actually closed?

Answer to Q.19 It is clear that the specialist system, as such, cannot be expected to make an "orderly" market in the older sense of this term, in the face of the massive imbalances of buy and sell orders that can occur in today's institutionalized, automated market. It is too early to tell (or at least I personally have no knowledge) whether the corrective measures that were applied experimentally in the last two triple witching hours were successful, or whether the different system that will be in effect for the next triple witching hour will be successful.

Q.20. Do you think that Congress should commission a study such as the 1963 Special Study Report? Would you be willing to head a Study group? What specific legislative and regulatory reforms can be attributed to the recommendations of the 1963 Special Study Report?

Answer to Q.20 I believe many important topics are in need of thorough study. There are many ways of going about this, one of which would be a study such as the 1963 Special Study. Other approaches are outlined in my answer to question 10 of Senator Riegle's set of questions.

I personally would not be willing to head a study comparable to the 1963 Study.

Among many reforms stemming from the 1963 Special Study were the following: greatly strengthening the self-regulatory system with Commission oversight under the 1934 Act; extending the 1934 Act's corporate disclosure and proxy requirements to thousands of over-the-counter companies; improving performance and supervision standards relating to broker-dealer selling practices; and strengthening standards and controls regarding conduct of stock exchange specialists and floor traders as well as of professionals in the over-the-counter market. But what ultimately may have been more important than any of the immediate reforms, the Special Study made the first organized studies of some relatively new or just-emerging phenomena that seemed in need of regulatory attention, and possibly regulatory action. For example, we explored in depth the anomalous consequences of the fixed commission rate system of the exchanges and the quotation systems of the over-the-counter market; we made the first significant public study of the then relatively new phenomenon of institutionalization of the markets; we took the first serious look at interrelationships -- operational and competitive -- among markets; and we made a first start at studying the potentials of automation in the securities markets.

Q.21 You seem critical of the Administration regarding its avowed goal of deregulation. In the area of securities regulation, what specific programs or regulatory schemes have been dismantled which have had an adverse impact on the protection of investors? You also claim that the Commission has avoided new regulatory initiatives that might have been undertaken by a more activist Commission -- just what initiatives did you have in mind?

Answer to Q.21 Although I recognize that the pros and cons of any regulatory or deregulatory initiative may be debatable, I would refer to (among others) the following deregulatory initiatives: the withdrawal of proposed Rule 13e-2 relating to issuers' repurchases of their own securities and substitution of Rule 10b-18; various relaxations of Rule 10b-6 relating to security purchases during or prior to distributions; permitting brokers' "internalization" of customer orders without requiring order exposure; authorizing a pilot in side-by-side market-making in options and underlying stocks; allowing shelf registration of equities as well as debt securities, without a minimal waiting period for due diligence; permitting primary market specialists to be affiliated with firms engaged in other broker-dealer, investment banking or advisory activities; advocating total repeal of the Public Utility Holding Company Act, including prophylactic provisions designed to prevent rebirth of holding company abuses.

I would refer to the following situations (among others) where possibly needed regulatory initiatives have not been taken: absence of further measures to establish a national market system; risk arbitrage activities in connection with takeovers; possibly abusive tactics on the part of hostile takeover bidders and target companies; "corporate governance" matters which are closely related to takeover contests and over which the Commission may have authority other than through the Williams Act; program trading, proprietary trading, bridge loans, "securitization" of credit instruments and other new products and practices.

Q.22. Do you believe that the Delaware court's decision in Unocal Corp. v. Mesa Petroluem was correct? Do you think that the Commission was acting correctly when it adopted the so-called "all holders" rule.

Answer to Q.22 Although I believe that considerable latitude should be given to managements of target companies in defending against hostile takeovers, I was somewhat surprised at the Unocal decision in which the Delaware Supreme Court permitted, as a matter of state law, a selective (i.e., selective among stockholders of the same class) self-tender offer. On balance, I am inclined to agree with the Commission's action in adopting the so-called "all holders" rule.

The Commission's action had the effect, of course, of "reversing" or preempting the leading state law authority on the subject. I believe that the episode is a good illustration of the point that I made at pages 15-17 of my written Statement dated February 24, 1987, to the effect that the time has come for serious consideration of amendments to the 1934 Act to deal in a unified fashion with the present patchwork of federal law, state law, and a no-man's land of jurisdictional uncertainty with regard to corporate governance aspects of tender offers and defenses.

Outline of Some of the Recommendations
Made at the Securities Subcommittee Hearing
February 24, 1987

1. The EDGAR System of the Securities and Exchange Commission ("Commission") deserves the full support of the Congress and should be adequately funded.

2. The Commission should also be developing a vastly improved surveillance capability for all U.S. securities markets.

3. The Commission should be given cease-and-desist powers.

4. The Commission should be given the authority to impose fines as a general enforcement tool.

5. The Commission's traditional injunctive authority should be clarified to confirm the SEC's authority to seek a host of equitable remedies, such as the disgorgement of ill-gotten gains, the appointment of receivers, and the requirement that institutional violators of the federal securities laws be directed to implement prophylactic measures to ensure against a repetition of the violative conduct.

6. The Commission's disciplinary authority over broker-dealers should be clarified, so that there will be no dispute concerning the agency's power to suspend errant professionals for a period exceeding twelve months but less than a lifetime bar.

7. Legislation should be enacted to encourage foreign governments to enter into formal cooperative ventures with U.S. law enforcement authorities, similar to the memoranda of understanding between the United Kingdom and the United States and between Switzerland and the United States, to ensure mutual evidentiary assistance in cases of national importance.

8. Legislation should be enacted to authorize the SEC to require firm's professionals who are privy to market-sensitive, nonpublic information to adopt meaningful guidelines, much as section 17(j) of the Investment Company Act of 1940 requires portfolio managers of investment companies to adhere to standards adopted by their own firms.

9. The Commission's rulemaking authority should be expanded, to enable the agency to cope with changing investment products -- such as financial futures - and changing securities services -- such as the provision of discount brokerage services by depository institutions.

10. A study should be conducted by an independent committee commissioned by, and under the jurisdiction of Congress, with a

view toward recommendations for new legislation and improved regulations.

11. Exchanges should review their listing requirements with a view to eliminating unnecessary restrictions on foreign listings.

12. Congress should establish principles for allocating regulatory responsibilities along functional lines.

13. The Commission should eliminate the Short-Sale Rule which does not exist on the London and Tokyo Exchanges.

14. The Commission's sanctions for those who violate the law by their involvement in fraudulent financial reporting are not adequate and should be significantly increased.

15. Barring from corporate office those who cause, aid and abet, or participate in fraudulent financial reporting is an appropriate sanction, and one which ought to be regularly considered by the Commission in enforcement proceedings involving fraudulent financial reporting.

16. The current legislation regarding tender offers and related corporate transactions should be overhauled to eliminate obvious abuses and to conform the legislative scheme to the realities of today's markets and technologies.

17. Diligent consideration should be given to the elimination of "greenmail" and to a rule that would require full financing of tender offers before they are made.

18. Steps must be taken to assure that disclosures of material corporate information reach the public more quickly and effectively.

(a) Companies that file late or submit incomplete or inaccurate filings should be brought to task by the Commission.

(b) Congress should consider legislation to accelerate disclosure of market sensitive information, including: (1) filing of section 13(D) reports of substantial stock acquisition within 2 days of their acquisition rather than 10 days; and (2) acceleration of 16(A) reports of stock transactions by corporate insiders from 10 days after the close of the month to 2 business days after the transaction.

19. Legislation should be considered that clarifies and strengthens the definition of a "group" so as to assure appropriate disclosure under section 13(D) of concerted or coordinated activities relating to significant acquisitions of stock in publicly-held companies.

RESPONSES OF MILTON H. COHEN TO
SENATOR RIEGLE'S LIST OF RECOMMENDATIONS
OF WITNESSES AT THE SECURITIES SUBCOMMITTEE
HEARING OF FEBRUARY 24, 1987

(A copy of the list of recommendations, as attached to Senator Riegle's letter of March 10, 1987, is attached to these responses.)

1. I agree.

2. I believe there is a need for improved surveillance capability -- not necessarily on the part of the Commission itself but in coordination with improved surveillance systems of broker-dealer firms and self-regulatory organizations.

3. I have no present opinion.

4. I have no present opinion.

5. I am not aware of any need for clarification. The federal courts seem to be generally receptive to wide-ranging suggestions by the Commission and I believe there is by now a substantial body of precedents.

6. I believe there should be wide flexibility in fashioning appropriate sanctions and remedies. I do not know whether legislation is needed.

7. I agree that international cooperation should be fostered. I do not know whether legislation is needed to ensure mutual evidentiary assistance. Treaty negotiations may be necessary, however, to develop or foster common notions of wrongful market conduct.

8. I believe that the general idea of requiring broker-dealer firms to adopt meaningful standards and procedures to prevent misuse of non-public information is very sound. It is not clear to me whether legislation is necessary in light of Section 15(b)(4)(E) of the Securities Exchange Act of 1934.

9. The Commission's rule-making authority with regard to securities and securities markets seems generally adequate, except perhaps insofar as the Commission's present authority to define manipulative, deceptive or fraudulent devices is limited by a scienter requirement and does not more broadly reach unfair dealing with customers. With regard to "changing investment products" and "changing securities services" the problem is that the traditional lines of demarcation between types of products, types of markets and types of participants are increasingly blurred, so that regulatory agencies other than the Commission are involved. "Functional regulation" probably is the ultimate solution, but that will require reexamination of the regulatory authority of all of the involved agencies, not just the Commission.

10. The main burden of the written Statement that I presented to the Subcommittee on February 24 was that many important changes in the securities markets have occurred since 1963 (when the Special Study of the Securities Markets was completed) and that a study or studies to determine what changes in existing laws or regulations are now needed should be undertaken. The format of the study or studies could be any, or a combination, of the following: a "special study" conducted by the Commission through a specially-hired, independent staff, in the manner of the 1961-63 Special Study of Securities Markets; a special study conducted by an existing or special Congressional Subcommittee, perhaps with the assistance of specially-hired personnel, in the manner of the Securities Industry Study conducted by this Subcommittee in 1972, leading to its Report dated February 1973; or one or more studies of special topics by the regular staff of the Commission, similar to, e.g., the study of Limitations on Off-board Trading by Exchange Members presented to Congress in 1975, the study on Questionable and Illegal Corporate Payments and Practices presented to Congress in 1976, or the study of Corporate Accountability published in 1980.

11. As internationalization or "globalization" of the securities markets goes forward, the Commission's corporate disclosure and proxy requirements as well as the exchanges' listing requirements may need revision. Obviously, "unnecessary" restrictions on foreign listings (or domestic listings, for that matter) should be eliminated, but more difficult questions are how far we should be willing to go in relaxing which domestic requirements or restrictions so as to accommodate different systems or conceptions in other countries, and how far we may succeed in persuading foreign authorities to elevate their standards so as to conform more closely with our systems or conceptions.

12. I agree that efforts in this direction should be made. See No. 9 above.

13. See No. 11 above. As there stated, existing statutes and regulations may need to be reexamined in order to encourage or accommodate globalization of securities markets, but I do not believe there is any easy answer concerning any particular subject such as the short-sale rule. In other words, this is one of many topics that will need to be considered as part of a broad study or studies of whether, how far, and in what manner the regulatory system can and should accommodate globalization.

14. This question should be considered along with No. 15. My general impression is that regulations and surveillance mechanisms may need to be strengthened in some respects but that the range of penalties or sanctions presently available to the courts and the Commission is probably adequate.

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15. I would agree that barring from corporate office may be an appropriate sanction in some cases and therefore ought to be routinely considered. However, it would probably be an excessive sanction in most cases, and therefore its appropriateness must be considered in light of the seriousness of the violation and the form and degree of an individual's involvement in each instance.

16. There is far from any consensus in the corporate community, the financial community, or (I suspect) the legislative and regulatory communities as to what are "obvious abuses" or "the realities of today's markets and technologies" in respect of the tender offer area, and there is likewise no consensus as to what reforms may be needed. Without subscribing to the word "overhaul," I believe that a broad review of laws and regulations in the tender offer area is needed.

17. I agree that serious consideration should be given to the elimination of "greenmail" (as appropriately defined) and to a requirement that full financing be arranged (and the arrangements be disclosed) before a tender offer is made.

18. I agree with (a), assuming that "brought to task" does not mean a Draconian sanction in every case. As with other regulatory areas, remedial or punitive damages obviously should be proportionate to the seriousness of the deficiency. Probably a more important point is that the Commission's budget should be increased so that filings can be promptly and expertly reviewed.

I agree with (b). I would add that, in addition to accelerating the filing of Schedule 13D reports, (i) the report form should be revised with a view to making inquiries more searching, and (ii) consideration should be given to defining actions or events earlier than the accumulation of 5% of voting securities that might be considered significant enough to trigger a disclosure obligation.

19. I strongly agree, but I would add that some types of relationships (such as those with investment banks and broker-dealer firms) may be more effectively reached by expanding the disclosure requirements of Schedule 13D than by using the "group" concept.

Harvey L. Pitt*
Responses to Recommendations and Questions, Senate Securities Subcommittee
April 28, 1987

1. The EDGAR System of the Securities and Exchange Commission ("SEC" or "Commission") deserves the full support of the Congress and should be adequately funded.

EDGAR (the Commission's Electronic Data Gathering, Analysis and Retrieval system) carries the potential for maximizing the efficiency and fairness of the marketplace in the United States and, in my view, certainly deserves Congressional support.

EDGAR is an electronic filing network designed to allow market participants to file time-sensitive corporate information from their own data processing equipment.1/ In addition to providing a more efficient alternative to the traditional delivery by hand of multiple copies of SEC filings, EDGAR will provide investors and analysts in-house access to vital information within minutes, a key to ensuring that market prices accurately and promptly reflect current information.

My only concern with the system, apart from the need for the Commission to receive the funding necessary to develop and maintain EDGAR effectively, is that the Commission also take steps to ensure that EDGAR will not increase the informational advantages enjoyed by market professionals and institutional investors over individual investors.

1/ See generally, SEC Budget Estimate Fiscal 1988, Ia-1,2 (1987)("SEC 1988 Budget Estimate"). The Commission continues to implement the EDGAR program, having requested funding necessary to move into the next phase of the project (SEC 1988 Budget Estimate at Ia-i - Ia-5) and adopted a temporary rule and form to facilitate the voluntary participation of institutional investment managers in EDGAR. 52 Fed. Reg. 9151, 9154 (Mar. 23, 1987) (to be codified at 17 C.F.R. § 240.13f-2(T)).

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*The views expressed in these comments are solely those of Mr. Pitt, and are not necessarily the views of his partners at Fried, Frank, Harris, Shriver & Jacobson or of any of the law firm's clients.

2. The Commission should also be developing a vastly improved surveillance capability for all U.S. securities markets.

We are beginning to see the potential as an enforcement tool of the surveillance systems employed by the self-regulators as they police their members. For example, in the first eleven months of 1986, the New York Stock Exchange ("NYSE") alone flagged over 9,000 "alerts," or situations of anomalous trading. The NYSE evaluated those alert situations and, regarding those which could not be explained by news announcements, brokerage firm recommendations or the like, opened 154 investigations.[2/] The NYSE referred 37 matters to the SEC during the first eleven months of 1986, and 65 for the twelve months of 1985.[3/] While the Commission has noted and suggested improvements for perceived shortcomings in the surveillance systems employed by the self-regulators, these systems have provided the Commission with investigatory leads which, in some cases, have resulted in important SEC enforcement actions.[4/]

2/ Statement of William J. Anderson Before the Subcommittee on Oversight and Investigations of the House of Representatives Committee on Energy and Commerce regarding, Bank Powers: Insulating Banks from the Potential Risks of Expanded Activities, GAO Report No. GAO/T-GGD-87-2 at 5-8, (Dec. 11, 1986).

3/ Id. at 7.

4/ During fiscal 1986, the Commission brought 34 administrative or civil proceedings involving insider trading, 24 of which stemmed from case investigations. Of the 24, nine case investigations had been initiated by referrals from self-regulators, and three others were initiated by either the market surveillance efforts of the self-regulators or the Commission. Id. Of the SEC enforcement investigations pending at the close of fiscal 1986, 10% had been initiated based on information provided by self-regulators. SEC 1988 Budget Estimate at II-1.

In 1985, the Commission abandoned its previous plan to develop its own pervasive surveillance system, having determined that the current network among the exchanges, in which the Commission participates, provided an adequate and more cost-effective substitute.5/ Although I agree that the cooperative effort of the Intermarket Surveillance Group6/ is

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5/ In 1981, the Commission conducted a pilot project entitled the Market Oversight Surveillance System (MOSS), with a view toward developing for the Commission direct surveillance capability over trading activities on stock and option trading markets. The Commission also intended MOSS to facilitate oversight of the self-regulators, examination of registered broker-dealers, and other Commission functions. MOSS was considered an alternative to development by self-regulators of their own surveillance system. In 1982, the latter alternative became more attractive due to Congressional criticism and Commission budgetary constraints. SEC Reports Progress on Development of Intermarket Surveillance System, Sec. Reg. & L. Rep. (BNA) No. 41, at 1792 (Oct. 22, 1982).

In 1985, the Commission issued its Final Report to the Senate Committee on Banking, Housing & Urban Affairs and the House Committee on Energy and Commerce Regarding the Market Oversight and Surveillance System (Jan. 15, 1985) ("MOSS Final Report"). That report explained that the successes of the Intermarket Surveillance Group ("ISG") contributed to the Commission's decision to terminate the MOSS project. MOSS Final Report at 14.

The ISG is a coordinated effort among surveillance staff from the various exchanges "committed to minimizing the potential for intermarket trading abuses." Id. at A-4. The Commission participates in the ISG in meetings and investigations, somewhat independent of conducting its own surveillance efforts.

6/ See supra, note 5.

an appropriate vehicle for coordinating combined self-regulatory organization and SEC surveillance efforts. I believe that the Commission should also receive Congressional support for continuing its own independent, but nonduplicative, surveillance program. 7/

In my view, it is essential that the Commission maintain a cohesive governmental presence, both monitoring the self-regulators' surveillance efforts and maintaining an independent oversight of market activity. To a great extent, that structure is present in the Commission's current inspection and enforcement programs, and I am hopeful that Congress will encourage the continued development of the Commission's independent surveillance capabilities. In that way, the public will benefit from the sophistication and pervasiveness of the combined self-regulatory organization and SEC surveillance programs, a combination which I believe is essential to maintaining the integrity of our marketplace.

7/ The competitive pressures inherent in industry self-management make it only reasonable for the Commission to maintain some form of its own program; budget allocations by the self-regulators may not always ensure the level of surveillance necessary to monitor market activities adequately.

3. The Commission should be given cease-and-desist powers.

As I suggested in my testimony,8/ I believe that the Commission should be granted cease-and-desist powers in order to augment the remedies currently available to the Commission for its enforcement efforts. Currently, the Commission often must rely upon judicially-crafted equitable remedies in its enforcement efforts, remedies which, in some cases, are available only when either the party under investigation consents to the remedy as a part of a settlement with the Commission, or the court before which the matter is pending takes an hospitable position regarding the availability of equitable relief.9/ Cease-and-desist powers would clarify the Commission's ability to obtain meaningful prophylactic relief outside the context of a settlement and without resorting to remedies that do not quite match the exigencies of a particular enforcement situation.

Currently, the Commission has the statutory authority to initiate and issue reports of investigation,10/ to suspend or bar brokers, dealers or persons associated with a broker or dealer from association with any registered broker or dealer, or to limit or censure their activities,11/ and to impose

8/ Written Statement of Harvey L. Pitt, Before the Securities Subcommittee of the Senate Banking, Housing and Urban Affairs Committee, Regarding the Securities and Exchange Commission at 21-22 (Feb. 24, 1987) (attached hereto as Exhibit A) [hereinafter cited as Pitt Feb. 24, 1987 Testimony].

9/ See, e.g., Dent, Ancillary Relief in Federal Securities Law: A Study in Federal Remedies, 67 Minn. L. Rev. 865 (1983).

10/ Section 21(a) of the Securities Exchange Act of 1934 (the "1934 Act"); 15 U.S.C. § 78(a) (1982).

11/ Sections 15(b)(4) and (6) of the 1934 Act; 15 U.S.C. §§ 78o(b)(4) and (b)(6) (1982).

restrictions upon registered investment advisers similar to those available for use against broker dealers.12/

In addition to these express remedies, and in order to halt activities immediately which are (or might be) harmful to the marketplace, the Commission may appeal to the equitable jurisdiction of the federal courts, requesting the issuance of an injunction against the continuation or perpetration of such activities in the future. This remedy, while appropriate in many instances, often tortures traditional analysis of equitable jurisdiction in order to allow the Commission to obtain relief. In some situations, the claim may be stale, or the danger of imminent and irreparable harm may be unclear; in these circumstances, an injunction may be an inappropriate remedy. The Commission's arsenal of enforcement weapons should be clear, procedurally and substantively sound, and analytically well-founded; these are often goals rather than realities, at this point.

Cease-and-desist powers would clarify the Commission's authority to seek relief in a broad variety of situations, and would afford the Commission a means to tailor the remedy to particular circumstances.13/ The notice and hearing provisions which necessarily would accompany cease-and-desist powers would provide the added advantage of allowing the Commission to develop the facts and the legal rationale of

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12/ Section 203(e) of the Investment Advisers Act of 1940 (the "Investment Advisers Act") 15 U.S.C. § 80b-3(e) (1982).

13/ The legislative history of the Act creating cease-and-desist remedies for the Commodity Futures Trading Commission ("CFTC") (Commodity Exchange Act, ch. 369, §§ 6b-c (1922) (codified as amended at 7 U.S.C. §§ 13a, 13b (1982)), indicated that the purpose of the Act was to provide more flexible remedies for the CFTC. S. Rep. No. 947, 90th Cong., 2d Sess. reprinted in 1968 U.S. Code Cong. & Admin. News (82 Stat.) 1682.

complex cases, subject to appellate review.[14/] In addition to placing the tasks of factual development in the hands of an agency already expert in securities cases, developing the cases at an administrative level also would relieve the federal court docket. Such powers would also afford the Commission an opportunity to offer prospective guidance to market participants by articulating, in the context of actual fact patterns, what exactly is the state of the law. And, finally, the Commission will obtain a clear, effective approach to stopping conduct which it views as violative of the law. A number of federal regulatory agencies have cease-and-desist powers,[15/] and there is no apparent policy reason of which I am aware that would support the wisdom of a different approach for the SEC.

14/ The Commodity Exchange Act contains provisions defining appellate review of CFTC cease-and-desist orders. See 7 U.S.C. §§ 13a, 13b (1982).

15/ See, e.g., 12 U.S.C. § 1464(d) (1982), 12 U.S.C. § 1818(b) (1982), and 19 U.S.C. § 1337(f) (setting forth the scope of cease-and-desist powers provided by Congress to the Federal Home Loan Bank Board, the Federal Deposit Insurance Corporation and the International Trade Commission, respectively).

4. The Commission should be given the authority to impose fines as a general enforcement tool.

Although I am in full support of the provisions already available to the SEC that allow it to seek from a federal court up to treble penalties under the Insider Trading Sanctions Act ("ITSA") (once an insider trading violation has been established),16/ I am not in favor of granting to the Commission either its own authority actually to impose fines, or the authority even to seek judically-imposed civil fines in conjunction with all its other enforcement efforts.

The rationale for the treble damage provisions of ITSA was both simple and compelling: in order to deter would-be insider traders, a meaningful remedy was essential. The mere imposition of an injunction, even when combined with a judicial order requiring an adjudicated insider trader to disgorge any ill-gotten gains,17/ was simply not an effective deterrent to

16/ See Insider Trading Sanctions Act of 1984, 15 U.S.C. § 78u(2)(A)(1982 & Supp. III 1985).

17/ In my view, ample support exists for the proposition that, once a federal court's equitable jurisdiction properly has been invoked, the court possesses implied authority to impose appropriate equitable remedies in addition to a statutorily-prescribed injunction. See, Securities & Exchange Commission v. Wong, 254 F.Supp. 66 (P.R. 1966). See also Samuel v. University of Pittsburgh, 538 F.2d 991 (3d Cir. 1976); Lester v. Parker, 235 F.2d 789, reh'g denied, 237 F.2d 698 (9th Cir. 1956); Bowles v. Skaggs, 151 F.2d 817 (6th Cir. 1945); Securities & Exchange Commission v. Los Angeles Trust Deed & Mortgage Exchange, 186 F.Supp. 830 (S.D. Cal. 1960) aff'd. in part and mod. in part, 285 F.2d 162 (9th Cir.), cert. denied, 366 U.S. 919 (1961).

Nevertheless, as I indicated in my testimony before

Footnote Continued

such violations. Something more than the risk of being apprehended and deprived of illicit profits was required, and ITSA supplied an important deterrent remedy.

The same rationale does not necessarily apply to other violations of the federal securities laws. Indeed, the grant of general fining power would tend to criminalize the remedial aspects of the federal securities laws, a result that seems both unnecessary and duplicative in light of the Department of Justice's heightened sensitivity to the need to prosecute a whole range of technical and nontechnical violations of the federal securities laws.18/

In any event, even if the Subcommittee were to conclude -- contrary to my stated views -- that the imposition of civil fines should be available as a general enforcement tool, I do not believe the SEC should be given the power to impose such fines itself (as opposed to seeking such relief from a federal court). Given the SEC's broad remedial powers, also granting it the capacity to impose civil fines might deprive regulated entities of the opportunity to challenge questionable SEC enforcement or regulatory positions, and might coerce pliancy at the cost of an orderly and efficacious development of the law.

17/ Footnote Continued From Previous Page

the Subcommittee (Pitt Feb. 24, 1987 Testimony at 20-22), I believe the Commission's authority to seek, and a federal court's authority to grant, other equitable remedies should be expressly set forth in the statutes the SEC administers.

18/ Indeed, U.S. Attorney Rudolph Giuliani mentioned last week that the SEC and the Justice Department were investigating a pattern of collusion involving investment bankers, corporate raiders, professional stock traders and money managers, referring generally to investigations which Giuliani indicated "may become public fairly soon." Giuliani Says U.S. Probing Insider-Trading "Collusion," Wash. Post, Apr. 23, 1987, at E 2.

5. The Commission's traditional injunctive authority should be clarified to confirm the SEC's authority to seek a host of equitable remedies, such as the disgorgement of ill-gotten gains, the appointment of receivers, and the requirement that institutional violators of the federal securities laws be directed to implement prophylactic measures to ensure against a repetition of the violative conduct.

This suggestion is one I proffered to the Subcommittee during its recent hearings, and I am pleased to reaffirm this position.19/ The scope of the equitable remedies that the Commission may seek in federal district court (under the provisions of the 1933 and 1934 Acts) is unclear beyond the well-recognized availability of injunctive relief. In my view, the provisions within the securities laws which establish the Commission's injunctive authority should be clarified to confirm the SEC's authority to seek a whole range of equitable remedies already viewed by the Commission as essential to its enforcement efforts, and currently available to the agency in the context of administrative proceedings.

Currently, the Commission has the statutory authority to initiate and issue reports of investigation,20/ to suspend or bar brokers, dealers or persons associated with a broker or dealer from association with any registered broker or dealer or to censure them or limit their activities,21/ and to impose restrictions upon registered investment advisers similar to those available for use against broker dealers.22/ These

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19/ Pitt Feb. 24, 1987 Testimony at 20-22.

20/ Section 21(a) of the 1934 Act; 15 U.S.C. § 78u(a) (1982).

21/ Sections 15(b)(4) and (6) of the 1934 Act; 15 U.S.C. §§ 78o(b)(4) and (b)(6) (1982 & Supp. 1987).

22/ Section 203(e) of the Investment Advisors Act; 15 U.S.C. § 80b-3(e) (1982 & Supp. 1987).

prophylactic remedies currently available to the Commission typically are imposed by consent in administrative proceedings, in lieu of full blown enforcement actions, or only in cases of egregious conduct.23/ The statutes administered by the SEC should be clarified to confirm the Commission's clear authority to seek from the district court these equitable remedies.

For example, the Commission currently enjoys express authority to request a court to appoint a receiver for a registered investment company under certain circumstances.24/ The Commission has argued with success that courts should appoint receivers in other situations, such as in cases against broker-dealers or ordinary issuers, creating an implied right of appointment in situations not expressly authorized by Congress. In my view, this inconsistency should be clarified by creating the express remedy of receivership in cases where gross abuse of "trust, or fraud, or mismanagement" is proven.25/

Additional remedies, currently unavailable to the Commission, should also be added to the Commission's enforcement arsenal. Similarly, as I discuss further in my responses to recommendations 3 and 6 posed by Senator Riegle, the Commission should be given the express authority to suspend broker-dealers from participation in the marketplace for periods greater than one year but less than permanently, and should be granted cease-and-desist powers.26/

23/ See, e.g., In re Rooney Pace, Inc., Exchange Act Release No. 19,453 27 SEC Docket 70 (Jan. 27, 1983). See generally Mathews, Recent Trends in SEC Requested Ancillary Relief in SEC Level Injunctive Actions, 31 Bus. Law. 1323 (1976).

24/ Section 42(a) of the Investment Company Act of 1940 (the "Investment Company Act"); 15 U.S.C. § 80a-41 (1982).

25/ Mathews, supra note 23, at 1325.

26/ I do not agree, however, that the Commission should be afforded the power to impose civil fines. See Pitt Response to Riegle Issue No. 4, supra at 8.

6. The Commission's disciplinary authority over broker-dealers should be clarified, so that there will be no dispute concerning the agency's power to suspend errant professionals for a period exceeding twelve months but less than a lifetime bar.

This recommendation is endorsed in my testimony.[27/] Currently, the Commission is authorized by Section 15(b) of the 1934 Act to impose a suspension of up to one year from participation in the United States securities markets as a broker or dealer in securities.[28/] Also under that section, the Commission may bar a defendant permanently from being associated with a broker or dealer, or may revoke the broker or dealer's registration.[29/]

27/ Pitt Feb. 24, 1987 Testimony at 22.

28/ Section 15(b)(4) of the 1934 Act; 15 U.S.C. § 78o(b)(4)(1982). Congress amended section 15(b) in 1975 and again in 1986 (to be effective July 25, 1987), among other things, to add to the statutory list of prohibited activities: taking a false oath, making a false report, bribery, perjury, burglary or conspiracy to commit any such offense (in 1975); and to add to the list of those subject to these powers: municipal securities dealers, insurance companies, fiduciaries or any person or entity required to be registered under the Commodity Exchange Act (in 1975), or government securities brokers or dealers (in 1986). Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97. Government Securities Act of 1986, Pub. L. No. 99-571 (effective July 27, 1987). Congress did not in either 1975 or 1986, however, provide the relief discussed herein.

29/ Section 15(b)(6) of the 1934 Act; 15 U.S.C. § 78o(b)(6) (1982).

In order to fashion intermediate remedies, the Commission has been forced to construct them by revoking a respondent's registration or barring the respondent permanently, while affording an opportunity to apply for readmission to the marketplace after a period of two years, three years, five years, or whatever period of time is deemed most appropriate, given the infraction.

While the Commission's makeshift, ad hoc restructuring of the Act may be within its authority, there is no reason for the statute to deprive the Commission of explicit remedies that would enhance the agency's enforcement power. The Commission's disciplinary authority over broker-dealers should be clarified to provide the Commission with the express power to suspend errant professionals for periods exceeding twelve months but less than permanently.30/

30/ In the past, the Commission has not always fared well when it has been challenged on its efforts to mold existing statutory restrictions to current market exigencies. See, e.g., Securities and Exchange Commission v. Sloan, 436 U.S. 103 (1978); American Bankers Association v. Securities and Exchange Commission, 804 F.2d 739 (D.C. Cir. 1986).

7. Legislation should be enacted to encourage foreign governments to enter into formal cooperative ventures with U.S. law enforcement authorities, similar to the memoranda of understanding between the United Kingdom and the United States and between Switzerland the United States, to ensure mutual evidentiary assistance in cases of national importance.

As I have indicated elsewhere in these responses,[31/] I believe that we have experienced in recent months a new climate of cooperation among governments concerned about the problems presented by the growing internationalization of the securities markets,[32/] including the expanded opportunities for insider trading. Our shared interests are conducive to a program of active discussions among and between the nations involved, and I encourage Congress to take full advantage of this spirit of cooperation as it considers the negotiation and ratification of treaties or other agreements with foreign states.

Despite the trend toward international cooperation, there are certain nations which inevitably will resist and rebuff overtures to enter jointly into mutual legal assistance treaties or informal memoranda of understanding providing for the exchange of information in insider trading and other securities fraud investigations.[33/] These nations may assert several grounds for rejecting such a proposal.

31/ See Pitt Response to D'Amato Question No. 4, infra at 65.

32/ See Exchange Act Release No. 21,958, 32 SEC Docket 1241 (Apr. 25, 1985), where the Commission stated that "[t]here are few surveillance mechanisms in place to safeguard the integrity of securities trading conducted simultaneously in multiple international markets."

33/ See Pitt Response to D'Amato Question No. 4, infra at 65.

Insofar as such agreements would allow the Commission access to information in insider trading cases, some nations may refuse to extend assistance on the ground that insider trading is not a violation of their own laws.[34/] Moreover, some nations may be motivated primarily by a desire to retain off-shore banking activity, which may represent a significant source of economic growth in the local jurisdictions.

Accordingly, Congress should consider a number of options which would increase the incentives of certain nations to enter into cooperative ventures.

First, Congress might consider steps to condition economic assistance to certain nations on the successful negotiation of treaties or agreements modeled on the Swiss-U.S. Memorandum of Understanding establishing procedures for the Commission to obtain access to bank account information otherwise subject to foreign nondisclosure laws. This strategy is not without precedent: the United States has previously excluded nations refusing to waive secrecy provisions from the tax exemptions allowed Americans attending conventions in other nations.[35/] This may be an appropriate time to consider measures such as withdrawal of trade concessions in response to those nations whose refusal to cooperate with international investigatory efforts demonstrates a plan to remain a safe haven for scoundrels avoiding such investigations. As such measures generate antagonism on the part of foreign governments, they should be reserved for only those states which have resisted extended, good-faith efforts by United States negotiators to reach a mutually-acceptable accommodation.

A second option which Congress could consider is a prohibition on the right of United States broker-dealers to

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34/ Such arguments may be made by way of reference to the concept of "dual criminality," that is, the principle that one state should not lend assistance to the prosecution by another state of conduct which is not a violation in both fora.

35/ See Pindling Complains of U.S. Pressure Over Bank Secrecy, Latin American Newsletters (Jan. 21, 1983).

execute orders emanating from foreign institutions in certain jurisdictions that are not parties to mutual legal assistance treaties or other agreements. Since such institutions depend on United States brokerage firms to execute trades on their behalf, a prohibition of the type described would place considerable pressure on offshore jurisdictions to negotiate with the United States. The list of jurisdictions subject to the potential bar would have to be drawn up carefully, however, as otherwise substantial amounts of trading would simply be diverted to other major foreign exchanges.

In contemplating any of these initiatives, the Subcommittee should obtain the views of the SEC and the Department of State.

8. Legislation should be enacted to authorize the SEC to require firm's professionals who are privy to market-sensitive, nonpublic information to adopt meaningful guidelines, much as section 17(j) of the Investment Company Act of 1940 requires portfolio managers of investment companies to adhere to standards adopted by their own firms.

As I noted in my testimony before the Subcommittee on February 24th,[36/] firms which provide services to companies involved in mergers or acquisitions and other investment banking and related services, or which are otherwise privy to market-sensitive, nonpublic information, should be required by law to set definite standards of conduct for their employees.

As a practical matter, most firms that regularly receive, or are otherwise privy to, market-sensitive, nonpublic information, have adopted some form of standards to govern the conduct of their employees vis-a-vis such information.[37/] And, it cannot be gainsaid that there are no firm guidelines that can prevent venal employees from acting venally. Nevertheless, legislation of the sort indicated would, in my view, serve a number of salutary purposes.

For one thing, the existence of firm guidelines provides important evidence of a firm's fidelity to existing statutory restrictions against insider trading. It communicates an important message to the investing public, as well as a firm's employees, that the firm's management adheres to the rule of law in this area, and expects its employees to do so as well.

36/ Pitt Feb. 24, 1987 Testimony at 22.

37/ See Pitt Response to D'Amato Question No. 5, infra at 73 (discussion of my general recommendations to law firms, brokerage firms and public corporations regarding the scope of procedural guidelines implementing such standards).

In addition, firm guidelines provide a measure of discipline for those employees who desire to comply with the law. By setting forth meaningful policies, standards and procedures, firms can assist employees who invest in securities to pursue an appropriate methodology to make sure that their investment decisions do not ignore appropriate standards, and are made after full compliance with sensible procedures designed to minimize the occurrence of unfair, or improper, use of confidential information.

Finally, the existence of a statutory requirement that firms adopt meaningful guidelines will make it possible to allocate responsibility more equitably, in the unfortunate event that future insider trading violations occur. Fundamentally, a firm that discourages insider trading violations, and undertakes appropriate steps to preclude such conduct by its employees, should be able to minimize, if not eliminate, its own institutional liability for the willfully wrongful conduct of its venal employees. If the firm is under a statutory obligation to, and in fact does, adopt proper procedures and policies, such an allocation of liability can occur most efficaciously, and will be more likely to be perceived as fair.

9. The Commission's rulemaking authority should be expanded, to enable the agency to cope with changing investment products -- such as financial futures -- and changing securities services -- such as the provision of discount brokerage services by depository institutions.

As I mentioned in my testimony,[38/] the Commission has attempted unsuccessfully to regulate financial futures[39/] and bank discount brokerage services[40/] as a part of the Commission's ongoing effort to maintain the integrity of the securities markets. In both of these instances, the Commission was on the right track, but its efforts were thwarted by judicial decisions holding that the Commission acted outside its legislative authority. In order to remedy this situation, Congress should provide the Commission with the express rulemaking authority necessary to achieve these two objectives as well as to deal with market innovations which fall appropriately under Commission purview.

In the financial instruments area, artificial lines have been drawn between largely indistinguishable financial futures and financial options, and the Commission has been denied jurisdiction over the former. As an historical matter, this resulted from a 1982 compromise between the Commission and the

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38/ Pitt Feb. 24, 1987 Testimony at 14-16; Pitt Response to Riegle Issue No. 10, infra at 24.

39/ Board of Trade of Chicago v. Securities & Exchange Commission, 677 F.2d 1137 (7th Cir.), and No. 81-2587 (7th Cir. Mar. 24, 1982), vacated sub nom. Chicago Board Options Exchange, Inc. v. Board of Trade of Chicago, 459 U.S. 1026 (1982).

40/ American Bankers Association v. Securities & Exchange Commission, 804 F.2d 739 (D.C. Cir. 1986).

CFTC, later ratified by Congress,41/ which was sparked, at least in part, by a lawsuit brought by the Board of Trade of the City of Chicago ("CBOT") challenging the Commission's approval of trading of GNMA options on the Chicago Board Options Exchange, Incorporated.42/ This has continued to be

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41/ The agreement between the SEC and CFTC ("SEC/CFTC Jurisdictional Accord") clarified that the Commission had jurisdiction over put and call options on exempt and nonexempt securities, certificates of deposit, groups or indices of securities, and, when traded on a national securities exchange, foreign currency, and that the CFTC had jurisdiction over futures contracts on exempt securities, certificates of deposit and broad-based indices of securities, as well as over options on futures and options on foreign currencies traded on a commodities exchange. See Exchange Act Release No. 19,125 [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,264 (Oct. 14, 1982). This was ratified by Congress in amendments to the 1934 Act and the definitions of the term "security" in other federal securities laws (Act of Oct. 13, 1982, Pub. L. No. 97-303, 96 Stat. 1409 (often referred to as the "Securities Acts Amendments of 1982")), and by amendments to the Commodity Exchange Act (Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294).

42/ The Congressional action led the Supreme Court to vacate the decision by the Court of Appeals for the Seventh Circuit that the Commission lacked jurisdiction over GNMA options. Board of Trade of Chicago v. Securities and Exchange Commission, 677 F.2d 1137 (7th Cir.) and Board of Trade of Chicago v. Securities and Exchange Commission, 679 F.2d 894 (7th Cir. 1982), vacated sub nom. Chicago Board Options Exchange, Inc. v. Board of Trade of Chicago, 459 U.S. 1026 (1982). A subsequent challenge by the CBOT of joint SEC/CFTC guidelines on options and futures on narrow-based stock indices was dismissed as unripe. Board of Trade of Chicago v. Commodity Futures Trading Commission and Securities and Exchange Commission, No. 84 C 1141, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,437 (Mar. 30, 1984).

a troublesome area for the Commission, since bifurcation of the markets in this manner makes little sense.

First, the different labels assigned to "options" and "futures" should not be permitted to obscure the fact that the financial instruments are most often used for the same purpose. By use of either of these instruments, investors are able to hedge their investments in the underlying financial instrument without actually trading the underlying instrument. Second, trading in both types of derivative instruments may influence and be influenced by trading in the underlying securities. Third, many of the same purchasers and brokers participate in both markets. The instruments, similar as they are, ought to be regulated by the same agency.

Unfortunately, however, they are not. The current jurisdictional split between the SEC and the CFTC over functionally identical "options" and "futures" artificially affects the marketplace by "tilting" market participants into the least regulated arena. As I have testified previously,43/ existing securities laws and regulations, as administered by the SEC and the various self-regulatory organizations, provide superior investor protections and superior assurances of market integrity than those governing the futures markets. Thus, the enactment of the 1982 Accord44/ in the spirit of jurisdictional compromise, should not be the last word on the matter. This situation calls for drawing the distinction between derivative and primary financial instruments along functional lines.45/

43/ Joint Written Statement of Irving M. Pollack and Harvey L. Pitt Submitted to the House Subcommittee on Telecommunications, Consumer Protection, and Finance of the House Committee on Energy and Commerce on H.R. 5447 and H.R. 5515, (Apr. 23, 1982). [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,264 (Oct. 14, 1982).

44/ See Exchange Act Release No. 19,125 [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,264 (Oct. 14, 1982).

45/ See also Pitt Responses to Riegle Issue No. 12, infra at 29.

Similarly, it is inconsistent with sound regulation and investor protection that securities discount brokerage services purveyed by depositary institutions and their subsidiaries are not subject to the same regulatory structure as those supplied by securities brokers and dealers registered with, and regulated by, the Commission.

In the Glass-Steagall Act[46/] and other securities and banking laws, Congress sought to erect high walls between the banking and securities industries, assigning to the SEC jurisdiction over the latter. However, as indicated by the increasing role of depositary institutions in the securities discount brokerage area, for example, these walls have become an ineffective barrier, prompting one commentator to term the Glass-Steagall Act "the Maginot Line of finance."[47/]

Noting the increasing importance of banks in the securities industry, the SEC determined in 1985 that the concept of the term "broker-dealer" should be altered to reach those banks acting as broker-dealers, and therefore promulgated Rule 3b-9.[48/] The rule followed the premise that the SEC should regulate institutions based upon their financial function rather than their character or "species." Since banks were acting out of character, functioning as broker-dealers, the SEC reasoned that these actions removed from them the definitional shield from SEC regulation ordinarily afforded to commercial banks. The Court of Appeals for the District of Columbia

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46/ Sections 16, 20, 21 and 32 of the Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended at 12 U.S.C. §§ 24 (Seventh), 377, 378 (1982 & Supp. III 1985)).

47/ Statement of James Robinson, Chairman and Chief Executive Officer of the American Express Co. before the Securities Industry Association's Annual Meeting Dec. 4, 1986, quoted in Horowitz, Glass-Steagall's Demise is Predicted; Auguries by American Express Chief, Several Others Dismay SIA, Am. Banker, Dec. 5, 1986, at 3.

48/ 17 C.F.R. § 240.3b-9 (1986).

Circuit invalidated Rule 3b-9, and although the SEC sought rehearing by that Court, rehearing was denied.49/ The Commission has announced that it will consider at an open meeting on Wednesday, April 29, 1987, whether to "send Congress proposed legislation to give it new authority over bank activities."50/

In both of the foregoing instances, the financial futures/options dilemma and the banking broker-dealer definition, the Commission's efforts to exercise regulatory jurisdiction have been rebuffed by the courts. Both of these matters are worthy of revisitation and corrective action by the Congress, in order to provide the Commission with the express legislative authority to clarify its role in regulating all financial instruments, irrespective of the nomenclature appended to such instruments, and to regulate securities brokerage services along functional lines, irrespective of the particular purveyors of such services or their owners.

49/ See American Bankers Association v. Securities & Exchange Commission, 804 F.2d 739 (D.C. Cir. 1986). See Banking Expansion Rep., Mar. 2, 1987, at 19.

50/ Rosenstein, SEC May Ask Congress for New Power to Regulate Bank Securities Activities, Am. Banker, Apr. 27, 1987, at 1.

10. A study should be conducted by an independent committee commissioned by, and under the jurisdiction of Congress, with a view toward recommendations for new legislation and improved regulations.

I strongly endorse this proposal, as noted in my testimony.[51/] In this context, it should be noted that the three major legislative initiatives involving federal securities legislation were each preceded by major studies of our capital markets. Prior to the passage of the Securities Exchange Act in 1934, the Senate Banking Committee, guided by its counsel, Ferdinand Pecora, conducted a sweeping review of our markets and the abuses that infected them.[52/] Prior to the passage of the 1964 amendments to the federal securities laws, Milton Cohen led a blue-ribbon group of outstanding young lawyers in the seminal Special Study of the Securities Markets, a monumental work that remains today as the most comprehensive and insightful evaluation of our market systems.[53/] And, prior to the adoption of the detailed Securities Acts Amendments of 1975, this Subcommittee conducted a three-year review of our markets and the Commission's regulation of them. It is time, once again, to conduct a comprehensive review of our markets with a view toward recommendations for new legislation and improved regulation.[54/]

51/ See Pitt Feb. 24, 1987 Testimony at 8-9, 22-23.

52/ Stock Exchange Practices: Hearings Pursuant to S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 (73d Cong.) Before the Senate Comm. on Banking and Currency (1932-1934) (frequently referred to as the "Pecora Hearings").

53/ SEC, Report of the Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963) (the "Special Study").

54/ I am not alone in calling for such a review. Among others, the Honorable Stanley Sporkin, former SEC

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This does not mean that all legislative efforts should be deferred pending the completion of such a study. As this Subcommittee is well aware, there are some areas in which both consensus and enthusiasm exist for changing the securities laws, particularly in the tender offer arena. In these situations, it may behoove Congress to act immediately while its support is clear. But, because a comprehensive overhaul of our securities laws may also be in order, I believe that Congress should direct a new Special Study, or Pecora Hearing, to provide it with the factual predicates required for a comprehensive reassessment and updating of our system of market regulation.

I suggest that the study group, under the direction of the relevant Congressional Committees, should include Congressional staff, SEC personnel, and private sector representatives, a group designed to encourage and influence the diverse perspectives within the financial marketplace. The burgeoning international securities activities alone are sufficient to prompt such a comprehensive study effort; certainly when combined with our domestic concerns, there is both need and impetus for a large-scale study at this time.

54/ Footnote Continued From Previous Page

enforcement chief, has been outspoken recently in suggesting the need for a new comprehensive study, patterned after the Special Study. Ingersoll, Democrats in Congress Aim To Curb Takeover Excess, Wall St. J., Feb. 17, 1987, at 30, col. 1.

11. Exchanges should review their listing requirements with a view to eliminating unnecessary restrictions on foreign listings.

To the extent that listing requirements are unnecessary for investor protection, I agree with this recommendation.

Attracting foreign listings to our domestic marketplace is an essential pursuit. With the competitive pressures mounting between world markets, any shifting of international investor activity to other markets could reduce our "invisible exports" of financial services. Similarly, to the extent that foreign issuers prefer to list their securities on foreign markets, the opportunity for servicing their listings and the corresponding investments remains unavailable to domestic markets.55/

We have seen indications that foreign markets may be raising their listing standards in order to provide better protection to investors who are accustomed to receiving SEC disclosure information.56/ These adjustments on the

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55/ Foreign issuers who are hesitant to enter the United States market tend to harbor a fear of the SEC's power and a reluctance, as they see it, to add to that power by divulging corporate information. They also express frustration at the Commission's outmoded methods of disclosure document filing. See generally Exchange Act Release No. 21,958 [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,759 (Apr. 18, 1985).

56/ American institutional investors are requesting more information about securities listed on other markets, having become accustomed to the high level of disclosure required by United States law. G. Melloan, Swiss Secrecy Yields to Global Pressures, Wall St. J., Apr. 14, 1987 at 33, col. 6. In response to the pressures of the global market, Nicholas Baer, the Chairman of the Zurich Stock Exchange, is reported as commenting: "If you can't lick them, join them." Id.

international front are increasing the competitive pressures upon our domestic markets. Consequently, it is even more important to examine the restrictions on foreign listings in order to determine whether some requirements might be eliminated as unnecessary.

Some steps have already been taken in this direction. For foreign issuers, the exchanges have relaxed the numerical listing standards, hoping to attract these companies by providing alternate listing standards which reduce the number of shares distributed in the United States otherwise required of a listing company.57/ Although this reduction may appear to compromise investor protection, a corresponding, affirmative requirement for sufficient world-wide distribution of the listed stock balances the leniency.58/ Adjustments such as these, structured with a view toward protecting investors as well as facilitating the entrance of foreign listings on our domestic markets, are the kinds of reform I believe will be healthy for our domestic capital markets.

57/ See, e.g., The New York Stock Exchange Listed Company Manual § 103.00-.04, at 1-3 (rev. May, 1985); American Stock Exchange Company Guide § 110, at 1-5 (1985).

58/ The Commission is also assisting the exchanges in these efforts. Recently, the Commission amended its 1934 Act Rule 3a12-8 to eliminate the requirement that futures on certain foreign government securities must be traded on a board of trade in the country issuing the securities. Exchange Act Release No. 24,209 [Current] Fed. Sec. L. Rep. (CCH) ¶ 84,111 (Mar. 12, 1987). This rule now allows certain Canadian, Japanese and United Kingdom government securities to qualify as exempt securities, adding to the investment opportunities available to United States investors. The Commission determined that eliminating the foreign listing requirement would not harm investors, but would "promote competition among boards of trades." Id.

The difficulty lies in preserving the most effective balance between making our domestic markets attractive to issuers, largely a function of the cost effectiveness of registration, and making the markets attractive to investors, largely a function of accurate, timely, detailed disclosure information. Thus, listing restrictions which are instrumental in ensuring investor protection by guaranteeing public access to material information are not "unnecessary," and should not be among those eliminated.

12. Congress should establish principles for allocating regulatory responsibilities along functional lines.

While I support the notion that regulatory responsibility in what is now becoming known as the "financial services industry" should be allocated along functional lines, I am concerned that this type of functional regulation be effected by Congress, through comprehensive legislation, and not through ad hoc administrative action.

Functional regulation is based on two important precepts. First, functional regulation presupposes that substance should prevail over form, and that regulation in the financial services industry should be based upon the nature of the products and services that the participants sell, rather than on their organizational structure. Thus, a commercial bank that offers discount brokerage services, or that sells interests in a fund for the collective investment of Individual Retirement Accounts ("IRAs") to its customers, should be subject to the same statutes, the same regulations, and the same regulatory agency as a securities firm that offers the same services.

Second, functional regulation is based on the conviction that each agency should be given the power to regulate the activities that fall within its expertise, regardless of the type of organization through which those activities are conducted. For example, the SEC -- the agency with the greatest amount of expertise concerning investor protection, capital formation and market integrity in the securities marketplace -- should have regulatory jurisdiction over all firms that engage in brokerage activities, whether they are organized as commercial banks, securities firms, insurance companies, department stores, or anything else.

The statutory structure of the financial services industry has long been based on the principle of functional regulation. Although the statutes speak in terms of industry classifications -- "banks" versus "securities firms" versus "thrift institutions" -- those industry classifications themselves reflect the functions that Congress intended these various types of regulated institutions to perform. This

statutory scheme was designed by Congress to prevent a blurring of the functional lines between various classes of institutions.

One of the most important aspects of this functional separation was the Glass-Steagall Act,[59/] a statute which was designed to erect a clear line of demarcation between the banking and securities industries. Enacted in response to the belief that the ill-advised securities operations of commercial banks and their affiliates had been largely responsible for the Great Depression, the Glass-Steagall Act was designed to prevent banking organizations "as completely as possible" from performing banking functions,[60/] and likewise to bar securities firms from taking on the role of commercial banks.

At the same time, Congress sought to minimize unnecessary regulatory burdens on the participants in the financial services industry. Thus, where certain classes of institutions were foreclosed from engaging in certain activities, Congress exempted such institutions from the corresponding statutory provisions regulating such functions. For example, "[s]ince the Glass-Steagall Act was thought, as a general matter, to exclude banks from the securities business, the securities laws, in turn, exempt banks from most facets of securities regulation."[61/]

59/ The Banking Act of 1933, 48 Stat. 194, commonly known as the Glass-Steagall Act, is codified in scattered sections of 12 U.S.C.

60/ Board of Governors of the Federal Reserve System v. Investment Company Institute, 450 U.S. 46, 62 (1981).

61/ See Statement of Daniel L. Goelzer, General Counsel, Securities and Exchange Commission, Before the House Subcommittee on Commerce, Consumer, and Monetary Affairs of the House Committee on Government Operations, at 3-4 (July 20, 1983). Accord Statement of K. Houston Matney, Chairman of Financial Institutions Committee of the North American Securities Administrators Association and Securities Commissioner of the State of Maryland Before the Senate Committee on Banking, Housing and Urban Affairs, at 5 (June 16, 1983).

The functional compartmentalization envisioned by Congress and incorporated into the statutory structure, however, has been eviscerated in part. Over the last fifteen years, each of the bank regulatory agencies has sought to relax various restrictions imposed by the Glass-Steagall Act on the conduct of securities activities by depository institutions. Banks and thrifts have been allowed to enter the discount brokerage business, both through affiliates[62/] and directly,[63/] to offer investment advice to their customers and others, such as mutual funds,[64/] and to combine these two services into full service brokerage,[65/] with the approval of their regulators. The Comptroller of the Currency (the "Comptroller") has encouraged national banks to market mutual funds for IRAs,[66/] and even the Board of Governors of the Federal Reserve System (the "Federal Reserve Board") has allowed banking organizations within its jurisdiction to take on the traditional underwriting

62/ Securities Industry Association v. Board of Governors of the Federal Reserve System, 468 U.S. 207 (1984).

63/ Clarke v. Securities Industry Association, 107 S. Ct. 750 (1987).

64/ Board of Governors of the Federal Reserve System v. Investment Company Institute, 450 U.S. 46 (1981).

65/ Natwest, Inc., 72 Fed. Res. Bull. 584 (1986); Opinion of the Comptroller of the Currency, American National Bank of Austin, Texas, [1983-84 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,732 at 87,178 (Sept. 2, 1983).

66/ See Investment Company Institute v. Clarke, 789 F.2d 175 (2d Cir.), cert. denied, 107 S. Ct. 422 (1986); Investment Company Institute v. Conover, 790 F.2d 925 (D.C. Cir.), cert. denied, 107 S. Ct. 421 (1986); Investment Company Institute v. Clarke, 793 F.2d 220 (9th Cir.), cert. denied, 107 S. Ct. 422 (1986); Investment Company Institute v. Clarke, Memorandum Order No. 6-86-0032-17 (W.D.N.C. Aug. 20, 1986).

role of investment banks by acting as agent in private placements.67/

These efforts have led to unseemly intramural squabbles between the bank regulatory agencies,68/ lapses in important protections for depositors and investors,69/ extensive litigation,70/ and a potential weakening of the government's

67/ Securities Industry Association v. Board of Governors of the Federal Reserve System, 807 F.2d 1052 (D.C. Cir. 1986).

68/ When J.W. Seligman & Co. sought to charter a so-called "non-bank bank," for example, the Federal Reserve Bank of New York told Seligman that its actions would expose Seligman to criminal penalties under Section 20 of the Glass-Steagall Act, and the Comptroller of the Currency told Seligman to ignore the Federal Reserve's threats. Letter from Ford Barrett, Assistant Chief Counsel, Comptroller of the Currency, to Mr. William E. Hazen, President, J. & W. Seligman Trust Co., N.A. (April 5, 1983). See, e.g., Comptroller Tells Firm It Needn't Heed the Fed., Wall St. J., Apr. 7, 1983, at 3; OCC Backs Company Threatened With Glass-Steagall Prosecution, 40 Wash. Fin. Rep. (BNA) 758 (1983).

69/ See, e.g., American Bankers Association v. Securities & Exchange Commission, 804 F.2d 739 (D.C. Cir. 1986).

70/ To date, there have been at least nineteen lawsuits involving the legality of various bank securities activities under the Glass-Steagall Act: Clarke v. Securities Industry Association, 107 S. Ct. 750 (1987); Securities Industry Association v. Board of Governors of the Federal Reserve System, 468 U.S. 137 (1984); Securities Industry Association v. Board of Governors of the Federal Reserve System, 468 U.S. 207 (1984); Board of Governors of the Federal Reserve System v. Investment Company Institute, 450 U.S. 46 (1981); Investment Company Institute v. Camp, 401

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control over monetary policy.71/ Nevertheless, the banking agencies have continued on a path toward elimination of the

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70/ Footnote Continued From Previous Page

U.S. 617 (1971); Board of Governors of the Federal Reserve System v. Agnew, 329 U.S. 441 (1947); Investment Company Institute v. Federal Deposit Insurance Corp., Nos. 84-1616, 85-5769, ___ F.2d ___ (D.C. Cir. Apr. 7, 1987); Investment Company Institute v. Clarke, 793 F.2d 220 (9th Cir. 1986), cert. denied, 107 S. Ct. 422 (1986); Investment Company Institute v. Conover, 790 F.2d 925 (D.C. Cir. 1986), cert. denied, 107 S. Ct. 421 (1986); Investment Company Institute v. Clarke, 789 F.2d 175 (2d Cir.), cert. denied, 107 S. Ct. 422 (1986); Investment Company Institute v. Clarke, Memorandum Order No. 6-86-0032-17 (W.D.N.C. Aug. 20, 1986); New York Stock Exchange v. Bloom, 562 F.2d 736 (D.D.C. 1977), cert. denied, 435 U.S. 942 (1978); Port of New York Authority v. Baker, Watts & Co., 392 F.2d 497 (D.C. Cir. 1968); Securities Industry Association v. Federal Home Loan Bank Board, 588 F. Supp. 749 (D.D.C. 1984); Investment Company Institute v. Chase Manhattan Bank, N.A., No. 87-1093 (D.D.C. filed Apr. 21, 1987); Securities Industry Association v. Board of Governors of the Federal Reserve System, No. 86-1412 (D.C. Cir. filed Oct. 9, 1986); Securities Industry Association v. Board of Governors of the Federal Reserve System, No. 86-2768 (D.D.C. filed Oct. 7, 1986); Securities Industry Association v. Conover, No. 83-3581 (D.D.C. filed Nov. 30, 1983). See also Board of Governors of the Federal Reserve System, v. Dimension Financial Corp. v. Board of Governors of the Federal Reserve System, 474 U.S. 361, (1986); Florida Department of Banking and Finance v. Board of Governors of the Federal Reserve System, 800 F.2d 1534 (11th Cir. 1986); American Bankers Association v. Securities & Exchange Commission, 804 F.2d 739 (D.C. Cir. 1986); Oklahoma Bankers Association v. Federal Reserve Board, 766 F.2d 1446 (10th Cir. 1985); First Bancorporation v.

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statutorily-created functional separations in the belief that circumvention of those federal laws that they consider outmoded is in the best interests of the financial system as a whole.

The failure of the bank regulatory agencies to remain faithful to the dictates of Congress is a very troubling development. In our system of government, the power to set legislative policy resides exclusively with Congress. Particularly when, as here, Congress has denied to the administrative agencies involved the authority to reshape the regulatory structure in order to accommodate agencies' views of "the changing financial needs of our economy,"72/ no administrative agency has the right, or the authority, unilaterally to recast Congress' policy choices into a form more suitable to the agency. Until the law is changed by Congress, therefore, those agencies charged with its

70/ Footnote Continued From Previous Page

Board of Governors of the Federal Reserve System, 728 F.2d 434 (10th Cir. 1984); Wilshire Oil Co. v. Board of Governors of the Federal Reserve System, 668 F.2d 732 (3d Cir. 1981), cert. denied, 457 U.S. 1132 (1982); Independent Bankers Association of America v. Conover, [1984-85 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 86,178, at 90,528 (Feb. 15, 1985).

71/ For example, the FDIC, by interpreting Section 21 of the Glass-Steagall Act to permit state nonmember banks to engage in any and all securities activities through subsidiaries and affiliates, may well prompt an exodus of banks from the Federal Reserve System in order to take advantage of this apparent loophole. See Statement of Bevis Longstreth, Commissioner, Securities and Exchange Commission, Before the Subcommittee on Telecommunications, Consumer Protection, and Finance of the House Committee on Energy and Commerce (June 16, 1983).

72/ A.G. Becker, Inc. v. Board of Governors of the Federal Reserve System, 693 F.2d 136, 141 (D.C. Cir. 1982), rev'd, 468 U.S. 137 (1984).

administration are duty-bound to enforce it as Congress wrote it and as Congress intended it to be applied.

The failure of the bank regulatory agencies to respect their proper role in our system of government has also created a hopeless mess out of the regulatory structure of the financial services industry. As a result, some agencies have felt compelled to attempt to impose functional regulation on their own initiative in an attempt to rationalize the chaos that other agencies have created. These efforts have been held to exceed the agencies' statutory authority. The SEC's effort to regulate the brokerage activities of depository institutions, for example, was struck down by the United States Court of Appeals for the District of Columbia Circuit, which described the SEC's effort as "tantamount to one of the regulatory players changing the rules of the game."73/ The court agreed that the approach taken by the SEC might achieve "regulatory coherence," but declared that only Congress has the power and the authority "to allocate responsibility among different federal agencies for regulating financial institutions and market."74/ Likewise, the Supreme Court last year rejected the Federal Reserve Board's attempt to halt the proliferation of non-bank banks, stating bluntly that, if the statutory structure "falls short of providing safeguards desirable or necessary to the public interest, that is a problem for Congress, and not the Board or the courts, to address."75/

Consequently, if a framework of functional separation and functional regulation is to be reimposed on the financial services industry, it is up to Congress to do so. Such action should be taken, however, only as part of a comprehensive

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73/ American Bankers Association v. Securities & Exchange Commission, 804 F.2d 739, 755 (D.C. Cir. 1986). See supra, note 49 and accompanying text.

74/ Id.

75/ Dimension Financial Corp. v. Board of Governors of the Federal Reserve System, 474 U.S. 361, 106 S. Ct. 681, 689 (1986).

review of the developments in the financial services industry and a reexamination of the fundamental principles on which the statutory structure is based.

Reimposing a framework of functional regulation on the financial services industry would have a variety of beneficial effects, one of which would be consistency. By entrusting to a single agency the power to interpret and apply a given set of laws, functional regulation would foster the development of consistent regulatory philosophies in each sector of the financial services industry and would eliminate the inconsistencies that have resulted from different agencies having overlapping jurisdiction over the same set of activities.

Functional regulation would also remove the incentives that currently exist to manipulate a firm's corporate structure in order to qualify for a preferable regulatory environment. If a commercial bank moves its brokerage activities into a wholly-owned subsidiary, for example, the subsidiary becomes subject to the SEC's broker-dealer regulations, even though the bank itself would not be. This situation creates a powerful incentive for commercial banks to keep their brokerage operations within a department of the bank in order to escape SEC regulation, even though such a course of action exposes the bank to greater risk. Willard Butcher, the chairman of Chase Manhattan Co., has even threatened that Chase's member bank subsidiary will drop its bank charter -- without changing its activities -- if Chase is not given expanded securities powers.76/ It is inconceivable that Congress intended to allow such perversions of the statutory structure.

Functional regulation, however, should not be used as an excuse to destroy the boundaries between banking and other elements of the financial services industry. The Glass-Steagall Act and the other federal banking laws were based on the belief that the banking industry is imbued with a public importance, and thus that banks should be insulated from risky activities that conceivably could endanger the banking

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76/ See But Butcher Says Chase May Not Remain a Bank at All, Am. Banker, Feb. 23, 1987, at 2.

industry's economic position or that could threaten public confidence in the stability and impartiality of the banking system. Before permitting banks to expand their activities across functional lines, Congress should examine carefully the consequences that would attend such a major change in national policy.

Because of their importance as financial intermediaries, banking institutions have also enjoyed a variety of privileges and subsidies, which were granted to them by Congress in order to reduce the costs of financial intermediation and to foster confidence in the banking system. Before banks are permitted to enter the securities business, Congress should resolve the extent to which these advantages -- which are quite substantial -- would provide a competitive advantage to banks in their nonbank activities.77/ Similarly, any legislation in this area must preclude banks from subsidizing their non-banking enterprises through their banking operations.

Finally, comprehensive legislation to restructure the financial services industry should be grounded in principles of fairness. If the boundaries between various segments of the financial services industry are to lifted, they must be lifted equally, so that participants on both sides of the fence can take equal advantage of such freedom. For example, if banks are to be given new securities powers and are to be regulated in that regard in the same manner as securities firms, then securities firms should be given an opportunity to compete with banks in areas previously reserved to banks, subject of course to the applicable banking regulations.

77/ United States Department of the Treasury, Public Policy Aspects of Bank Securities Activities: An Issues Paper, at 14 (Nov. 1975).

13. The Commission should eliminate the Short-Sale Rule which does not exist on the London and Tokyo Exchanges.

Rule 10a-1,[78] the Commission's Short-Sale Rule, is designed "to prevent manipulative sales of a security for the purpose of accelerating a decline in the price of such security."[79] In the absence of manipulation, however, the Commission views short selling as not only proper, but also advantageous to the market,[80] and indeed, even necessary (in

78/ 17 C.F.R. § 240.10a-1 (1986).

79/ Exchange Act Release No. 20,715 [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,509 (Mar. 6, 1984). In describing the short sale dilemma, Congress noted that:

> Few subjects relating to exchange practices have been characterized by greater differences of opinion than that of short selling. The proponents of short selling contend that it is a necessary feature of an open market for securities; that in a crisis short sellers are useful in maintaining an orderly market; and that their activities serve as a cushion to break the force of a decline in the price of stocks. Its opponents assert that short selling unsettles the market, forces liquidation, depresses prices, accelerates declines, and has no economic value or justification.

Stock Exchange Practices, Report of Comm. on Bank & Currency, S. Rep. No. 1455, 73d Cong., 2d Sess. 50 (1934).

80/ Securities and Exchange Commission, Report of Special Study of Securities Markets of the Securities and

Footnote Continued

some instances) to facilitate the orderly and effective functioning of the securities markets.81/

The Commission, entrusted by Congress to determine the best way to deal with short sales,82/ has chosen not to regulate by evaluating the conduct in question in order to determine whether it was manipulative. Instead, the Commission has drawn lines between certain activities, identifying behavior not constituting a short sale, behavior excepted from the short sale rule, and behavior prohibited by the rule.83/ In addition, the Commission has identified certain market participants who are not subject to the short sale rule, even when their behavior might otherwise constitute a short sale.84/ Unfortunately, these lines of demarcation may not always serve to separate manipulative from nonmanipulative conduct, and thus may not always serve the purpose of the rule.

80/ Footnote Continued From Previous Page

Exchange Commission pt. 2 (1963), reprinted in H.R. Doc. No. 95, 88th Cong., 1st Sess. 293, pt. 2 (1963) reprinted in H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 2, 293 (1963).

81/ Exchange Act Release No. 13,091 [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,837 at n. 84 (Dec. 21, 1976). Exceptions to the rule allow short sales by market makers and specialists who act to stabilize the market during volatile periods. See 17 C.F.R. § 240.10a-1(e) (1986).

82/ Congress determined in 1934 that the Commission should determine the parameters under which short selling should be allowed on our domestic markets. See S. Rep. No. 792, 73d Cong., 2d Sess. 9 (1934).

83/ 17 C.F.R. § 240.10a-1 (1986).

84/ Id.

As with any bright-line distinction, the short sale rule may at times cast too wide a net, prohibiting conduct which is not manipulative,85/ and at other times may not cast a net at all, allowing the conduct to satisfy the short sale rule and then relying upon other 1934 Act provisions to restrict the conduct if it is in fact manipulative.86/

85/ For example, when a firm engages in proprietary trading in one account and pursues a "hedge" or "basket" strategy in the other, although the hedge or basket is an approved trading strategy and is not conducted with the intent to manipulate the market by selling short, in the course of unwinding the index arbitrage position, the firm may be deemed by the technical requirements of Rule 10a-1 to be short-selling. See e.g., Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC No-Action letter, File No. TP 87-19 (Dec. 17, 1986) (the Commission granted no-action status to Merrill Lynch for activity similar to that described above).

86/ For example, the short sale rule applies to securities which are traded on national securities exchanges except certain stocks listed on smaller, regional stock exchanges, but not to those listed on NASDAQ or otherwise traded in the over-the-counter market. 17 C.F.R. § 240.10a-1(a)(ii) (1986). The Commission reaffirmed this distinction when it amended Rule 10a-1 in 1986, but retained as an exception from the rule for transactions in securities designated as National Market System Securities, which are the larger, more liquid securities traded on the NASDAQ. Exchange Act Release No. 22,975 [1985-86 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,968 (Mar. 6, 1986).

Although the opportunities for short selling may be fewer when reported prices are not available through the Consolidated Tape Association, it seems inconsistent that the rule should be applied with such a broad brush. 17 C.F.R. § 240.10a-1(a)(ii) (1982).

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Although problems are easy to discern, many facets of short-selling (not the least of which is the economic impact of the rule upon investment banking firms) have not yet been studied sufficiently to warrant a major revision of the rule. Consequently, I recommend that the studies on the topic be consolidated and evaluated in conjunction with the Independent Study, which I have suggested as a vehicle for presenting to Congress recommendations for new legislation and improved regulation.87/

86/ Footnote Continued From Previous Page

Even though the Commission has chosen not to apply the short rule to these securities, the self-regulators nevertheless monitor their markets for manipulative short sales. At the request of the NASD, SEC Commissioner Irving Pollack conducted a study of short-selling practices in the over-the-counter securities market. Pollack, Short-Sale Regulation of NASDAQ Securities, an NASD publication (July, 1986). Mr. Pollack concluded that actions taken by the NASD to allow it better to regulate the practice were positive steps but that additional steps should be taken by the NASD to solve the problems which had been identified as the result of concentrated short selling. Id. at 4.

87/ See Pitt Feb. 24, 1987 Testimony at 8-9, 22-23; Pitt Response to Riegle Issue No. 10, infra at 24.

14. The Commission's sanctions for those who violate the law by their involvement in fraudulent financial reporting are not adequate and should be significantly increased.

As a general proposition, I believe the sanctions available to the Commission to combat fraudulent financial reporting are both adequate and effective. The Commission can deal with its financial reporting concerns through its rulemaking power, and through a variety of enforcement tools, including (i) investigative reports; (ii) injunctive actions; (iii) administrative proceedings pursuant to Section 15(c)(4) of the 1934 Act; and (iv) the referral of egregious cases to the Department of Justice for criminal prosecution.

In addition, I have recommended the enactment of two other remedies that would enhance the Commission's effectiveness against fraudulent financial reporting -- cease-and-desist powers,[88/] and a clarification of the Commission's ability to seek equitable remedies.[89/]

Beyond these recommendations, there is no reason to believe that the remedies available to the SEC to deal with fraudulent financial reporting are inadequate. The Commission's current campaign against faulty financial reporting dates back to the mid-1970's,[90/] and has been one of the Commission's most effective and active enforcement programs.[91/]

Indeed, as I noted in my written testimony before the Subcommittee,[92/] the Commission has, all too frequently,

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88/ See Pitt Response to Riegle Issue No. 3, supra at 5.

89/ See Pitt Response to Riegle Issue No. 5, supra at 10.

90/ See SEC Report on Questionable and Illegal Corporate Payments and Practices (May 12, 1976).

91/ SEC 1988 Budget Estimate at II-4.

92/ Pitt Feb 24, 1987 Testimony at 13.

resorted to its enforcement powers, instead of its rulemaking authority, to attack financial reporting that is at worst ill-considered or inappropriate, but not fraudulent. In many situations of true professional doubt, the Commission has asserted its staff's certainty, and charged companies with "fraud." I am persuaded that the Commission would do well to utilize its rulemaking powers more frequently in the financial reporting area. In any event, it is difficult to perceive any need for additional enforcement tools to address fraudulent financial reporting.

15. Barring from corporate office those who cause, aid and abet, or participate in fraudulent financial reporting is an appropriate sanction, and one which ought to be regularly considered by the Commission in enforcement proceedings involving fraudulent financial reporting.

I disagree with this recommendation. The premise underlying our federal securities laws has always been that the business of running a corporation should be regulated by the states, while the SEC should look out for the interests of shareholders by requiring adequate disclosure.93/ Our federal disclosure requirements facilitate the dissemination of information to shareholders, information which serves them in determining whether to purchase shares and helps them to make informed decisions, such as those concerning the election of directors. The Commission should continue to focus its efforts on ensuring accurate and timely disclosure, in order to provide adequate information for the shareholders to consider in their voting decisions.

Barring errant market participants from repeating fraudulent financial reporting violations is a meaningful response to activities of that ilk. The integrity of the financial marketplace must be preserved, and the Commission should be able to act as a referee, barring participants who

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93/ See, e.g., Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977); Piper Aircraft Corp. v. Chris-Craft Industries, Inc., 430 U.S. 1 (1977); Cort v. Ash, 422 U.S. 66, 84 (1975) ("Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation."). See also, CTS Corp. v. Dynamics Corp. of America, 55 U.S.L.W. 4478 (U.S. Apr. 21, 1987).

abuse marketplace disclosure needs from ever doing so again. But, the intricacies of corporate governance are another matter entirely. The Commission must not be made into a super-corporate regulator, but rather should focus upon protecting the marketplace by establishing meaningful regulatory requirements and enforcing fidelity to them.

As the Supreme Court noted last week, "[n]o principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders."[94/] In a word, it is for the states to address issues of corporate governance, not the SEC.

If the SEC believes that the conduct of corporate officers vis-a-vis a fraudulent financial report is particularly egregious, or is apt to be repeated, the use of an injunction combined with the potential of criminal prosecution should be adequate. And, the Commission's regulations currently would require principal officers and directors to disclose to shareholders the imposition of such sanctions.[95/] If, after governmental prosecution and full disclosure, the laws of the state in which a particular company is organized permit the sanctioned corporate official to run for corporate office, or be appointed to one, the Commission would be overreaching its proper role if it sought to substitute its judgment for that of a state legislature, or a company's shareholders (and/or directors) by removing such a person from corporate office.

94/ CTS Corp. v. Dynamics Corp. of America, 55 U.S.L.W. 4478 (U.S. Apr. 21, 1987).

95/ See Item 401(f)(5) of Regulation S-K, 17 C.F.R. § 229.401(f)(5) (1986).

16. The current legislation regarding tender offers and related corporate transactions should be overhauled to eliminate obvious abuses and to conform the legislative scheme to the realities of today's markets and technologies.

The Commission has been ill-equipped, in the best of circumstances, to keep pace with rapid private sector innovations in the takeover arena. In recent times, takeover contests have been characterized by a variety of new techniques, some of which are highly questionable and patently unfair, that raise significant questions about the adequacy of the existing tender offer regulation mechanism.

Thus, for example, the Commission's failure to respond to unconventional "tender offers," creeping acquisitions, untimely Schedule 13D filings, open market acquisition programs, "poison pills" and the like, has acted to the detriment of the investing public. Concerns about the risks of takeovers by corporate raiders have distracted corporate managements and caused an undue focus on short-term profitability. This, in turn, has had a negative effect on our international competitiveness, as research and development, capital investment, quality control and other activities that pay long-term dividends have been pared in the name of short-term financial performance.

A clear consensus has developed in favor of particular legislative changes to address those concerns, and I see no reason to postpone implementing those changes. One clear example is the consensus in favor of closing the 13D ten-day window, which is long overdue. Virtual unanimity exists that we now have the technological capacity to manage reporting within, at most, two days,96/ and it may be appropriate to

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96/ See Securities and Exchange Commission, Advisory Committee on Tender Offers: Report of Recommendations 22 (July 8, 1983). Of course, to achieve this objective certain mechanical issues will

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require reporting by the opening of the next business day following the purchase.

Other reforms to the tender offer process should be considered at this time, as well. Currently, the practice known as "sweeping the Street"[97] allows acquisition of control of a company without the investor protections of the tender offer regulations. Shareholders often are forced to make hasty selling decisions without having the benefit of adequate disclosure.[98] The Commission has considered and received favorable comment on a proposed "cooling off period" after tender offers cease; it may be an appropriate time to seek legislation requiring such a pause in the takeover scheme.

One proper and essential purpose of tender offers is to provide meaningful checks on management. But the tender offer process should, in my opinion, be overhauled so that its primary drawing card is not that it can be implemented in order to provide opportunities for deleterious speculative conduct.

96/ Footnote Continued From Previous Page

have to be addressed, including, for example, the difficulty of filing manually signed documents within a two-day window.

97/ In this practice, a bidder purchases large blocks of shares on the open market, primarily from arbitrageurs who have acquired them in response to the offer. These sellers are favored over ordinary investors since they have the opportunity to sell the shares at a high price (usually the tender offer price) without proration. See, e.g., Hanson Trust PLC v. SCM Corp., 774 F.2d 47 (2d Cir. 1985), rev'd, sub nom. Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986). See also Campeau to Divest Some Allied Assets, N.Y. Times, Nov. 3, 1986, at D-5, col. 1, (regarding Campeau Acquisition Corporation open-market purchase of Allied Stores Corporation shares).

98/ In addition to the disclosure problems, "sweeping the Street" raises other substantive unfairness issues. See Pitt Response to D'Amato Question No. 8, infra at 85.

17. Diligent consideration should be given to the elimination of "greenmail" and to a rule that would require full financing of tender offers before they are made.

The ability of a target company to repurchase shares from dissident shareholders at a premium has fostered incentives for investors to accumulate blocks of shares, not for the purpose of acquiring the company, but rather, for the purpose of reselling the shares back to the company itself. Unfortunately, this result most commonly occurs in the form of company "debt suicide," forcing shareholders wishing to retain their ownership interest in the company to endure the imposition of enormous debt.

In anticipation of this problem, many companies have adopted anti-greenmail provisions in their charters.99/ In my view, companies that wish to adopt such charter provisions should be free to do so, and companies are often well-advised to avoid the payment of greenmail in any event. But, I would not recommend the imposition of a legislative standard vis-a-vis greenmail for all public companies. In some instances, the payment of greenmail may be in a company's best interest, as well as in the best interests of its shareholders. I prefer to see the subject governed by state law and by application of the business judgment rule.100/

99/ Typical anti-greenmail provisions prohibit a corporation from buying back shares of its own stock at a premium above the market price in order to ward off corporate raiders. See GTE Rebuff Call to Spin Off Stake in Sprint, Wall St. J., Dec. 26, 1986; Transworld Corp. Plans Buyback Liquidation Voted, Wall St. J., Dec. 22, 1986.

100/ See, e.g., Lewis v. Daum, No. 6733, slip op. (Del. Ch. May 24, 1984) (directors may approve a repurchase providing for a premium to the selling stockholder in exercise of their business judgment); Cheff v.

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I am in favor, however, of requiring the existence of meaningful financing capacity for proposed tender offers before they are made. At present, companies can be put "in play" by the announcement of a tender offer for which actual financing is not currently available, or by the filing of a Schedule 13D suggesting a very aggressive approach toward the target by persons either having no intention of acquiring the target, or lacking the capacity to do so.101/

100/ Footnote Continued From Previous Page

Mathes, 41 Del. Ch. 494, 199 A.2d 548 (1964) (greenmail purchase sustained where acquisition was believed to be necessary to maintain proper business practices even though hindsight indicates the decision was not the wisest course). See S.E.C. Review of "Greenmail", N.Y. Times, Apr. 3, 1987, at D-9, col. 1.

101/ See Pitt Response to Riegle Issue No. 19, infra at 55.

18. Steps must be taken to assure that disclosures of material corporate information reach the public more quickly and effectively.

(a) Companies that file late or submit incomplete or inaccurate filings should be brought to task by the Commission.

(b) Congress should consider legislation to accelerate disclosure of market sensitive information, including: (1) filing of section 13(D) reports of substantial stock acquisition within 2 days of their acquisition rather than 10 days; and (2) acceleration of 16(A) reports of stock transactions by corporate insiders from 10 days after the close of the month to 2 business days after the transaction.

I agree that steps can, and should, be taken to facilitate the dissemination of material corporate information to the public even more promptly than occurs at present, and I believe that the key to achieving that goal is to focus on two concepts: timeliness and accuracy.

There is no doubt that the Commission should pursue companies that file late or submit incomplete or inaccurate filings to the agency. And, for over a decade, the Commission's Division of Enforcement has had, and has pursued, a program to chase delinquent and late filers.102/

102/ SEC 1988 Budget Estimate at II-4; See, e.g., Securities & Exchange Commission v. Diversified Growth Corp., 595 F. Supp. 1159 (D.D.C. 1984); Securities & Exchange Commission v. Beisinger Industries Corp., 552 F.2d 15 (1st Cir. 1977). See also SEC 1988 Budget Estimate at I-4 (discussing the Division of Corporate Finance efforts at preventing inaccurate or misleading disclosure).

Concommitantly, 1934 Act Rule 12b-25 does permit companies to defer the timely filing of all, or a portion, of a required statement where exigent circumstances exist and appropriate disclosures are made.103/

I also agree that Congress should promptly enact legislation that would require immediate, or virtually immediate, filing of Schedules 13D and insider transaction reports pursuant to Section 16(a) of the 1934 Act. As I have indicated in my responses to Riegle Recommendation No. 16 and D'Amato Question No. 8, infra, I believe that this Subcommittee should not hesitate to close the so-called 13D ten-day window, except insofar as it must determine whether to reduce the period to two days, or to require next-day or same-day reporting. I also am in favor of requiring insider transaction reports pursuant to Section 16(a) to be filed within two business days after the transaction. Our technological capacity has reached the point that such filings are easily accomplished, and would obviate the potential for volatile market activity during the period when the public has not been notified of concerted purchasing or selling activity covered by those reports and schedules.

In order to ensure that the steps you mention will be effective, however, a more basic concern must be addressed: the Commission must, in my opinion, revive the belief that inaccuracies or inadequacies in SEC filings will be caught by the Commission in its review process. Unfortunately, that basic function has slipped in recent years, to the detriment of market participants. The Commission's traditional policy of reviewing each disclosure document filed in its office has been replaced by the simple hope that the percentages of disclosure documents reviewed will merely increase each year.

103/ See 17 C.F.R. § 240.12b-25 (1986) (any report or portion of report required to be filed may be filed late if registrant could not timely file without unreasonable effort and expense, but the registrant must then file within a time period specified by the provision and must state reasons why the report could not be timely filed).

Issuers no longer expect filings to be reviewed -- in fact, SEC officials urged at a recent presentation to securities lawyers that issuers should not be surprised upon learning that the Commission has initiated a review,104/ a statement which indicates that the review process no longer extends to all filings.

Until recently, it was the Commission's policy to review filed documents with a vigor designed to guarantee this compliance. In 1975, the Commission reviewed every 1933 Act registration statement, whether from a new or repeat issuer. It also reviewed every annual meeting proxy statement and every annual, quarterly and current report.105/

This policy of 100% review, a tradition at the Commission, was abandoned in the late 1970s and early 1980s, as the combination of increased filings and inadequate staffing made pursuit of the traditional policies frustrating. Thus, in 1986, the Commission reviewed only 72% of the new-issuer 1933 Act registration statements. Even more disturbing, during 1986 the Commission reviewed only 27% and monitored only 22% of repeat-issuer 1933 Act registration statements, reviewed only 19% and monitored only 6% of all annual meeting proxy statements filed, reviewed only 17% and monitored only 4% of all annual reports filed, and reviewed only 5% and monitored only 22% of all quarterly and current reports filed with the Commission.106/

The dramatic increase in filings has contributed to this slide in the Commission's traditional 100% review policy: review of the Commission's performance over the past twelve years demonstrates that the actual number of filings reviewed has increased, but the increases in reviews are not large

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104/ Statement of Linda Quinn, at SEC Speaks, Washington, D.C. (March 14, 1987).

105/ SEC 1977 Budget Estimate, 32-46 (1976)("SEC 1977 Budget Estimate").

106/ SEC 1988 Budget Estimate at I-10, 11 (all figures are rounded to the nearest percent).

enough to close the gap caused by increased filings.107/ The Commission, noting this problem, enhanced its efforts in 1986 to improve the review percentages of 1985.108/ This extra effort resulted in a significant increase in the percentage of 1933 Act registration statements reviewed.109/ But even after requesting increases in its budget, the Commission predicts that no increases in the percentages of filings reviewed will occur for 1933 Act registration statements or for any other filing category for 1987 or 1988.110/

Companies filing disclosure documents should expect, without question, recrimination for failure to comply with these disclosure rules either substantively or procedurally. Unfortunately, there exists enough of a question to dilute the salutary effects of Commission review, and I believe it is time for Congress to secure for the Commission the funds essential to return the review process to its previous efficacious levels.

107/ Compare SEC 1977 Budget Estimate at 35 with SEC 1988 Budget Estimate at I-16. In 1986, the Commission reviewed 72% of the new issuer registration statements filed, compared to only 60% in 1985. SEC 1988 Budget Estimate at I-13. New issuer registration statements were the only filings that received greater Commission attention in 1986, however; the percentages of reviews remained relatively stable or actually decreased in other categories. In fact, the Commission reviewed only 17% of the 1934 Act Annual Reports filed in 1986, compared to 21% in 1985. Id.

108/ Id. This effort continues, as the Commission changes the focus of its review staff. In its SEC 1988 Budget Estimate, the Commission indicates that the number of full reviews conducted depends directly upon the percentage of accountants in the review process, a number which the Commission hopes to increase to at least 50%. Id. at I-6 - I-8.

109/ See supra note 107.

110/ See SEC 1988 Budget Estimate at I-10 - I-12.

19. Legislation should be considered that clarifies and strengthens the definition of a "group" so as to assure appropriate disclosure under section 13(D) of concerted or coordinated activities relating to significant acquisitions of stock in publicly-held companies.

Although Section 13(d) of the 1934 Act was intended to require the disclosure of potential or actual sudden movements in corporate ownership,[111/] in its application the section may fail to pick up disclosure of various activities which fall within the scope of that purpose. Consequently, I agree that legislation should be enacted which clarifies the definition (and concept) of the term "group," in order to allow Section 13(d) to achieve its purpose.

When organized operations involving arbitrageurs and others join in takeover activities which increase the possibilities for market manipulation,[112/] those activities should fall clearly within the statutory definition of the term "group." Such operations certainly impact upon the target company, and it is often operations of this sort which affect share prices most emphatically. Similarly, when significant acquisitions are made by members of an extended family or by purchasers relying upon advance knowledge of others' purchases or intended purchases, it may be appropriate to deem such relationships the equivalent of a "group" for purposes of Section 13(d) filing requirements.[113/]

111/ S. Rep. No. 550, 90th Cong., 1st Sess. 7 (1967); H.R. Rep. No. 1711 90th Cong., 2d Sess. 8 (1968); 1968 U.S. Code Cong. & Admin. News (82 Stat.) 2818.

112/ See Tender Offers, SEC Funding to Dominate 1987 Congressional Action on Securities, 19 Sec. Reg. & L. Rep. (BNA) No. 3, at 99, 101 (Jan. 16, 1987).

113/ Courts have applied a functional analysis of the "group" definition, finding a group when the purpose

Footnote Continued

In addition, I believe other aspects of the Section 13(d) filing requirements should be examined. In my view, Congress also should consider whether purchasers reporting under Section 13(d) who state that they are purchasing "for investment purposes only" should be barred from making a tender offer for that security for a period of time after the date that an amended Form 13D -- changing the disclosure of the filer's purposes -- is filed. A similar "cooling off" period should be required if the prior Schedule 13D filing is comprised of boilerplate language that describes many investment options but gives no indication of the investor's plans or the probability that any of the options might be acted upon.114/

In any event, I believe that the time is ripe for Congress to consider, either by itself or with the support of a Special Study such as that discussed in my response to question 10, above, legislation which would clarify and strengthen the "group" definition.

113/ Footnote Continued From Previous Page

of the statute is furthered. See, e.g., G.A.F. Corp. v. Milstein, 453 F.2d 709 (2d Cir. 1971), cert. denied, 406 U.S. 910 (1972).

114/ Greene & Junewicz, A Reappraisal of Current Regulation of Mergers and Acquisitions, 132 U. Pa. L. Rev. 647, 668 (1984).

Q. 1. Some of my colleagues have urged that we must enact tender offer reform legislation designed to curb takeover activity in an effort to curtail insider trading activity. Should any amendments to the Williams Act that we consider be influenced by a desire to eliminate insider trading or are these (insider trading and tender offer reforms) separate issues which should be addressed by separate legislative proposals?

There is, in my view, a link between the recent insider trading violations that have occurred, and the current tender offer phenomenon. Nevertheless, tender offer reform and insider trading prohibitions are separate issues, which I believe should be addressed by separate legislative proposals.115/

In contemplating amendments to the Williams Act, the Congress must necessarily consider the legal abuses that have been uncovered in the tender offer process as a result of the ongoing governmental investigations into insider trading and related activities. And, effective tender offer reform may well reduce the opportunities for insider trading, and therefore, curtail the practice. But, it would be inappropriate to consider extensive Williams Act amendments (beyond the specific recommendations I have suggested) other than as part of a comprehensive review and restructuring of the laws relating to tender offers.116/

115/ I have recommended specific changes to the 1934 Act to address each of these issues. See Pitt Feb. 24, 1987 Testimony at 11, 13-14, 21; Pitt Response to Riegle Issue No. 16, supra at 46; Pitt Response to D'Amato Question Nos. 3 and 8, infra at 63 and 85.

116/ On or before May 25, 1987, at the Subcommittee's request, a group of attorneys of which I am a part will submit a legislative proposal to address directly the problems that inhere in the current law relating to insider trading. See Pitt Response to D'Amato Question No. 3, infra at 63.

Q. 2. Some of our colleagues have argued that tougher sanctions are needed to deter insider trading. Are more penalties needed or are more policemen to enforce the existing laws prohibiting insider trading sufficient? Do you think that the sanctions imposed on Dennis Levine were adequate to send a message to Wall Street (2 years in jail, $350,000 in criminal penalties in addition to the millions of dollars in civil penalties)?117/

The existing remedies against insider trading violations are varied and extensive. The SEC has the express capacity to enjoin inside traders from future violations,118/ to seek the imposition of a civil penalty of up to three times the profits made (or loss avoided) by the inside trader,119/ and to bar permanently (or suspend for up to one year, or limit the activities of) any broker or dealer in securities, or any person associated with such a broker or dealer.120/ In addition, the SEC has the implied authority to require all inside traders to disgorge any ill-gotten gains, as an exercise

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117/ Dennis Levine consented to the entry of a permanent injunction against future violations of the securities laws and was ordered to disgorge assets totalling $11.6 million. He was also barred permanently from the securities industry. Levine Admits Stock Fraud; Will Aid Probe, Wash. Post, June 6, 1986 at A1. In a related criminal action, Levine pled guilty to securities fraud, income tax evasion and perjury. On February 20, 1987, Levine was sentenced to two years in prison and was fined $362,000. Levine Gets 2-Year Jail Term, N.Y. Times, Feb. 21, 1987 at 33.

118/ Sections 21(a) and 27 of the 1934 Act.

119/ ITSA, 15 U.S.C. § 78u(2)(A) (1982 & Supp. 1985).

120/ Section 15(b)(4) and (6) of the 1934 Act.

of a federal court's equity jurisdiction.121/ Finally, any insider trading violation is a felony, with each count carrying a maximum punishment of up to five years in jail, and a fine not exceeding $100,000.122/

While these remedies and penalties have served the Commission well, particularly in recent times, there is a need to revisit the current statutory framework. As I noted in my prepared testimony before the Subcommittee on February 24, 1987,123/ I believe the Commission's authority to seek disgorgement of ill-gotten profits should be made explicit.124/ I also recommend that Congress enact legislation that would (1) clarify the definitions pursuant to which inside traders can be prosecuted civilly and

121/ ITSA, Pub. L. No. 98-376, 98 Stat. 1264 reprinted in 1984 U.S. Code Cong. & Admin. News 2274, 2280-81, 2297. See, e.g., Securities & Exchange Commission v. Tome, 638 F. Supp. 596, 627 (S.D.N.Y. 1986) (SEC brought action for an injunction and other ancillary relief, including disgorgement of ill-gotten gains. In enacting ITSA, Congress underscored the importance of the disgorgement remedy in SEC injunctive actions); Securities & Exchange Commission v. Grossman, No. 87-1031, Slip op. (S.D.N.Y. Feb. 17, 1987) (Commission seeking disgorgement of illegal profits plus civil penalties under ITSA); Securities & Exchange Commission v. Ablan, No. 84 Civ. 8532, [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,847, at 90,230 (S.D.N.Y. Nov. 27, 1984) (Commission sought disgorgement of illegal profits made while trading on material non-public information).

122/ Section 32 of the 1934 Act (except that no person may be imprisoned if he proves he had no knowledge of such rule or regulation).

123/ Pitt Feb. 24, 1987 Testimony at 22.

124/ See also Pitt Response to Riegle Issue No. 5, supra at 10.

criminally;[125/] (2) permit the Commission to require institutions and firms that are privy to material, nonpublic information to adopt guidelines to protect against the misuse of such information;[126/] and (3) strengthen the SEC's hand in obtaining the cooperation of foreign governments in the SEC's important overseas information-gathering efforts.[127/]

In addition to these remedies, I am concerned that the SEC is seriously understaffed, underpaid, and deprived of necessary facilities to perform up to its full potential. As I noted in my prepared testimony before the Subcommittee,[128/] there can be little doubt that the Commission lacks both the resources and the remedies that are necessary if the agency is to deter securities law violations in the most efficacious manner.

Although the Commission has requested funding for additional staff positions during fiscal years 1987 and 1988,[129/] a belated but encouraging recognition of its personnel limitations, the Commission's proposals will not serve to alleviate backlogs and deficiencies in a whole host of Commission programs. Many of the most highly qualified law school graduates are opting for private practice rather than accept SEC salaries that are up to $40,000 per year lower. The bright and dedicated professionals who are still attracted to the SEC for a portion of their careers cannot avoid being struck by the grossly higher rewards garnered by their contemporaries in the private sector; retaining these professionals in Commission employment has become an almost impossible goal. The complexities of securities regulation

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125/ Pitt Feb. 24, 1987 Testimony at 13-14, 21; Pitt Response to D'Amato Question No. 3, infra at 63.

126/ Pitt Response to Riegle Issue No. 8, supra at 17.

127/ Pitt Feb. 24, 1987 Testimony at 22; Pitt Response to Riegle Issue No. 11, supra at 26; Pitt Response to D'Amato Question No. 4, infra at 65.

128/ Pitt Feb. 24, 1987 Testimony at 17-20.

129/ SEC 1988 Budget Estimate at vii.

demand sophisticated and experienced "policemen," as your question describes them; we cannot afford to abandon these standards in the name of consistency with the majority of governmental agencies or tradition at the Commission.

I have proposed that the Commission be relieved of the salary constraints traditionally imposed by the civil service laws, in order to allow the Commission the flexibility already afforded the Board of Governors of the Federal Reserve System.130/ This can be accomplished by a simple expedient: placing the Commission on a self-sustaining basis.131/ I have also proposed that the Commission be given the power to negotiate its own lease, free of the constraints imposed by budget limitations and the General Services Administration.132/ The Commission's currently overcrowded facility is no longer adequate to handle the business conducted inside. Alleviating the Commission's budgetary and manpower constraints should be, I respectfully submit, a top priority for this Subcommittee.

As to the second part of your question, regarding the adequacy of insider trading sanctions imposed by the courts, it is my view that the imposition of criminal penalties requires a case-by-case evaluation of factors relevant to the individual or entity being sentenced -- decisions that are properly confided to the federal judiciary. Our government has both the capacity and the inclination to detect illegal activity and to bring offenders to task. Public awareness of this fact is crucial to the confidence necessary to maintain the integrity of our United States marketplace.

In order to encourage this confidence and to deter illegal conduct, the securities laws currently provide the judiciary with a variety of sentencing alternatives. In imposing a sentence, the judiciary must be free to evaluate all factors, including the severity of the infraction, the defendant's cooperation with government efforts in further investigations and the potential deterrent effect a sentence might have on others operating in the marketplace. In my opinion, balancing these considerations is a task best left to federal judges, who are entrusted with the responsibility and who carry the capacity to temper justice with mercy.

130/ Pitt Feb. 24, 1987 Testimony at 18-19.

131/ Id. at 17-20.

132/ Id. at 19-21.

Q. 3. What legislation would you recommend to provide added deterrence? Should we provide a statutory definition of insider trading to provide greater guidance to participants in the securities markets? (England, France and, by this summer, Switzerland have or will have statutes on the books that define insider trading.)

Chairman Riegle has requested that I coordinate an effort to present to this Subcommittee a proposed definition of insider trading. This effort is already underway, and its participants and observers include representatives from this Subcommittee's Staff, the private sector and the Commission.

I believe that the substantive law applicable to insider trading should be overhauled to remove uncertainty, clarify the misappropriation theory[133/] and define the concept of insiders. Legitimate business people face a fair amount of uncertainty in ascertaining the precise reach of the law

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133/ The problems with the misappropriation theory are clearly illustrated in the present Supreme Court case of United States v. Carpenter, (known as the Winans case from its district court title) which, of course, is a criminal case brought by the U.S. Attorney and not by the SEC. Carpenter involves a former Wall Street Journal reporter who allegedly gave trading tips in reliance on the expected publication dates of press columns involving the securities in question. It is unfortunate that his liability under the federal securities laws should hinge, as the lower courts held under the judicially-developed "misappropriation theory," on whether the Wall Street Journal had an announced policy favoring or opposing such activity. United States v. Carpenter, 791 F.2d 1024 (2d Cir.), cert. granted, 107 S. Ct. 666 (1986).

See also Chiarella v. United States, 445 U.S. 222 (1980).

pertaining to insider trading and the steps they should take to assure compliance. The Commission has answered the absence of a definition of insider trading not by regulation, but rather by developing normative standards in the context of enforcement proceedings or civil litigation.

Lawmaking by enforcement, in particular, is a troublesome concept, especially for those who may find themselves thrust in the role of "test" cases. Relying upon case-by-case litigation to develop the law predictably has resulted in public confusion about precisely what conduct the Commission believes violates the law and a series of judicial decisions that only serve to make enforcement tasks more difficult.134/

Defining insider trading will remove most of this uncertainty, but the definition should also preserve flexibility for enforcement purposes, a preeminent concern of the SEC. Those are our goals as we prepare our proposal for your review.

134/ An example of this can be seen in Dirks v. Securities & Exchange Commission, 463 U.S. 646 (1983), where the Supreme Court reversed an SEC enforcement action against Raymond Dirks. Dirks, having learned of an issuer's fraud from its former employee and having failed to persuade the SEC or the Wall Street Journal to investigate the matter, advised his clients of the information, sparking a sell-off.

The Court rejected the SEC's novel theory for Dirks' liability in that matter, holding that the Commission's Rule 10b-5 cannot be read to bar trading on undisclosed material inside information by a corporate outsider who owed no fiduciary duty to disclose or refrain from trading. As the Dirks case indicates, not only are efforts to make new law through enforcement proceedings unfair, they are also frequently unsuccessful.

Q. 4. How can we effectively deter insider trading when transactions can be executed from off-shore locations where insider trading is not illegal? To curtail insider trading, shouldn't we attempt to enter into treaties with foreign countries which require reciprocity or a more uniform policing of securities fraud in the U.S. and international markets?

As you have indicated, insider trading is far from a purely domestic phenomenon. Illicit transactions on United States markets are frequently executed from off-shore financial institutions.135/ Given the international scope of the problem, and the fact that many foreign jurisdictions have enacted nondisclosure laws which erect significant, if not impenetrable, barriers to the discovery of critical evidence by the SEC,136/ United States law enforcement efforts to deter insider trading require equal measures of tenacity and diplomacy. In this framework, the negotiation of treaties with foreign governments to provide for the exchange of information, on a mutual and cooperative basis, in investigations of securities fraud in the United States and international markets should play a central role.

The value of treaties and informal agreements between nations can best be understood by comparing such measures with other options currently at the SEC's disposal when attempting to obtain evidence from abroad in connection with an investigation of potential insider trading. Initially, the SEC

135/ Indeed, the Dennis Levine case, which sparked the current flurry of insider trading investigations, involved trading through a Bahamian bank account. See Securities & Exchange Commission v. Levine, No. 86 Civ. 3627 (RO) (S.D.N.Y. May 12, 1986).

136/ See generally Law of May 24, 1965, BGB2 835 (W.Ger.) and The Protection of Trading Interests Act, 1980, ch. 11.

may encounter difficulty in attempting to effect valid service of an investigative subpoena on the repository of evidence located abroad.137/ Assuming, however, that the SEC has served a valid investigative subpoena, and that the recipient of the subpoena is a person or institution maintaining assets in the United States, the Commission may attempt to ensure compliance with the subpoena through the maintenance of subpoena enforcement suits in the federal district courts,138/ and call for stiff fines in the event of subsequent noncompliance with the court's order. In the latter

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137/ In repeated cases, the United States courts have upheld service of SEC subpoenas served in the United States requiring the production of evidence located abroad. See, e.g., Securities & Exchange Commission v. Minas de Artemisa, S.A., 150 F.2d 215 (9th Cir. 1945); Securities & Exchange Commission v. Banca Della Svizzera Italiana, 92 F.R.D. 111 (S.D.N.Y. 1981). The SEC would meet with a different reception, however, were the agency to attempt to require a person not found in the United States to testify or produce documents from abroad. See, e.g., Commodity Futures Trading Commission v. Nahas, 738 F.2d 487 (D.C. Cir. 1984) (court refused to enforce investigative subpoena served upon a Brazilian citizen in Brazil). In addition, service may violate local foreign law, or foreign courts may decline to enforce an order for noncompliance. See e.g., X AG v. A bank, [1983] 2 All E.R. 464.

138/ SEC subpoenas are not self-executing, and the Commission has no independent power to impose sanctions for noncompliance with a subpoena. Instead, the SEC must file a subpoena enforcement suit in federal district court, and the court may order compliance with the subpoena, continued failure to do so subjecting the recipient of the subpoena to sanctions for contempt. See, e.g., Section 21(c) of the 1934 Act.

regard, the SEC and other federal agencies have met with a considerable degree of success in recent years.139/

The Commission itself is well aware of the antipathy and resentment with which other sovereign nations view SEC subpoenas calling for the production of evidence located abroad, not to mention the imposition of sanctions on foreign entities with assets in this country by United States courts.140/ In my view, it is important to focus upon cooperative ventures wherever possible in order to avoid what may be an understandable antagonistic nationistic reaction to coercive efforts.141/ Where possible, the Commission attempts to take advantage of existing multinational and

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139/ See, e.g., In re Marc Rich & Co. A.G., 707 F.2d 663, 667 (2d Cir.), cert. denied, 463 U.S. 1215 (1983); In re Grand Jury Proceedings, United States v. Bank of Nova Scotia, 691 F.2d 1394 (11th Cir. 1982), In re Grand Jury Proceedings, United States v. Field, 532 F.2d 404 (5th Cir.) cert. denied, 429 U.S. 940 (1976).

140/ For example, in 1984, the Commission's request for comments on a concept release relating to a "waiver by conduct" proposal, the members of the American Bar Association's Subcommittee on SEC Practice and Enforcement Matters and I urged the Commission not to endorse, propose or sponsor the contemplated legislation, in the interest of avoiding unilateral action when possible. Comment letter of Richard M. Phillips and Harvey L. Pitt in response to Exchange Act Release No. 21,186 [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) (July 30, 1984). Instead of supporting the legislation, the members suggested that the proper solution to the inefficiencies of international law enforcement is to support a "coherent response by all affected countries, even though achieving that response involves the costs and delays of diplomacy. Id. at 2.

141/ See Pitt Response to Riegle Issue No. 7, supra at 14 (for additional discussion of this topic).

bilateral treaties and agreements for the exchange of information. Resort to such treaties and agreements by the SEC can prove highly efficient, saving the Commission both time and resources, and further establishes a foundation for future cooperation by demonstrating the United States' commitment to negotiated solutions.

Currently, the United States is a party to three treaties providing for mutual legal assistance in criminal matters,142/ and has concluded negotiations with other countries as to similar treaties not yet in force.143/ These treaties have already assisted the Commission in its efforts to deter insider trading; they should contribute substantive precedents as our government continues its efforts to develop similar treaties with other nations.144/

142/ Treaty on Mutual Legal Assistance, June 12, 1981, United States-Netherlands, T.I.A.S. No. 10,734; Treaty on Extradition and Mutual Assistance in Legal Matters, June 7, 1979, United States-Turkey, T.I.A.S. No. 9891; Treaty on Mutual Assistance in Criminal Matters, May 25, 1973, United States-Switzerland, 27 U.S.T. 2019, T.I.A.S. No. 8302 (entered into force Jan. 23, 1977).

143/ Among the significant agreements recently negotiated are the Treaty Relating to Mutual Legal Assistance in Criminal Matters, United States-United Kingdom (concerning the Cayman Islands) (done July 3, 1986); Treaty on Mutual Legal Assistance in Criminal Matters, United States-Canada (done March 18, 1985).

144/ To date, the bulk of the Commission's experience with mutual assistance treaties has been with the Treaty on Mutual Assistance in Criminal Matters between the United States and Switzerland (the "Swiss-U.S. Treaty"). The fact that the SEC is an administrative agency seeking information primarily for use in civil proceedings does not preclude the agency from obtaining evidence pursuant to the treaty, as long as the Commission's investigation relates to the subject of a potential criminal action. Under most

Footnote Continued

In particular, the Swiss-U.S. Treaty contains a stipulation that information will be provided only in connection with offenses deemed criminal in both the United States and Switzerland. This "dual criminality" requirement has created a significant impediment to obtaining information in insider trading cases from Switzerland, since insider trading is not yet punishable per se in Switzerland.145/

In addition to these formal contracts between nations, the Commission has also been able to take advantage of various memoranda of understanding ("MOU") between enforcement agencies of different nations; these MOUs provide for the sharing of information in investigations of securities fraud and insider trading.146/ MOUs are particularly helpful to the Commission

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144/ Footnote Continued From Previous Page

circumstances, however, the evidence may not be used in a civil proceeding unless previously used in a criminal proceeding, a provision that clearly inhibits SEC investigatory efforts.

145/ The latter impediment may be removed soon. Legislation to criminalize insider trading in Switzerland has been presented to the Swiss Parliament. The bill passed the Upper House and is expected to become effective in 1987. Swiss Banking 3; In the Bankers' Chair, Fin. Times, Dec. 10, 1986, at III.

146/ See Memorandum of Understanding on Exchange of Information Between the United States Securities and Exchange Commission and the United Kingdom Department of Trade and Industry in Matters Related to Securities and Between the United States Commodity Futures Trading Commission and the United Kingdom Department of Trade and Industry in Matters Relating to Futures (Sept. 23, 1986); Memorandum of the United States Securities and Exchange Commission and the Securities Bureau of the Japanese Ministry of Finance on the Sharing of Information (May 23, 1986); Memorandum of Understanding Between the Government of

Footnote Continued

and the Justice Department because they can be limited to the field of securities violations, or even to the narrower field of insider trading, unlike mutual assistance treaties, which operate with a broader brush.

With regard to insider trading, the most significant MOU to date is the U.S.-Swiss MOU, signed on August 31, 1982. The MOU does not itself set forth the criteria under which customer information will be released to the SEC in insider trading investigations, but instead refers to the terms of the accompanying private agreement among members of the Swiss Bankers' Association (the "SBA Agreement").147/ The SBA Agreement, in turn, provides for its own termination in the event that legislation criminalizing insider trading is enacted in Switzerland, in which case the SEC must resort to the Swiss-U.S. Treaty.

The SEC recently made use of the U.S.-Swiss MOU in a case involving allegations of insider trading in the securities of RCA Corp.148/ The SEC s experience in the Katz case supports the conclusion that the Commission is able to gather evidence under the U.S.-Swiss MOU on a timely basis: the SEC obtained disclosure of the customer of a Swiss bank within a short time after first approaching the Swiss authorities with a request. The Commission's success under the U.S.-Swiss MOU in this instance, together with its success in negotiating MOU's with Japan and the United Kingdom, suggests that it is an approach well worth pursuing with other nations with nondisclosure laws.

I believe this is a particularly propitious time for the administration to negotiate additional mutual assistance

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146/ Footnote Continued From Previous Page

the United States of America and the Government of Switzerland [hereinafter cited as "U.S.-Swiss MOU"] (Aug. 31, 1982).

147/ Agreement XVI of the Swiss Bankers' Association.

148/ Securities & Exchange Commission v. Katz, No. 86 Civ. 6088 (S.D.N.Y. Aug. 7, 1986).

treaties and to encourage the SEC to pursue further memoranda of understanding, for several reasons. First, a number of nations other than the United States have recently called for the strengthening of their own prohibitions against insider trading, which is indicative of the growing international consensus that insider trading is a harmful activity.149/ Second, I am encouraged by the increasing spirit of cooperation among securities regulators in various nations, a climate which I believe will facilitate the exchange of market information on a global scale.150/ Finally, Congress' current determination to define insider trading will, in my opinion, greatly assist our efforts to negotiate new agreements, since other nations will prove more likely to lend assistance to United States law enforcement efforts if they can have greater confidence that the conduct in question is clearly culpable.

Notwithstanding the improved climate for international cooperation, some countries may remain steadfast for the foreseeable future in their determination to block investigations of suspect trading activity emanating from their borders. With regard to these nations, attempts to establish a basis for voluntary cooperation may prove fruitless, and Congress should seriously consider as an alternative what pressures it may justifiably seek to exert in order to obtain information.151/ Principles of international comity suggest, of course, that such measures should be taken only after attempts to achieve negotiated solutions have proved unavailing.

149/ See, e.g., Tougher Trading Laws, MacLean's, Dec. 22, 1986, at 38 (proposed amendment to Ontario Securities Act increasing maximum penalties for illegal securities trading to fine of $1.0 million; two years' imprisonment); Company Sanctions (Insider Dealings) Act 1985, ch. 8 (Mar. 11, 1985) (strengthening penalties for insider trading in the United Kingdom).

150/ For example, representatives of 58 countries attended a meeting in July, 1986 sponsored by the International Association of Securities Commissions, at which a standing committee was established to promote greater assistance in securities law enforcement.

151/ See Response to Riegle Issue No. 7, supra, at 14.

Q. 5. Since the enactment of the Federal Securities laws in the 1930's, self-regulation has been a basic tenet underlying securities regulation. Have the recent insider trading scandals revealed that most firms pay only lip service to self-regulation? What steps can the individual law firms, securities firms and corporations take to prevent insider trading? Have these firms been derelict in their duties of sending a clear message to their employees that insider trading will not be condoned by the firm?

I do not believe that securities firms have paid only lip service to self-regulation, or that they have been derelict in sending clear messages to their employees that insider trading will not be condoned. I feel strongly, however, that any entity which is involved in corporate takeovers or extraordinary corporate transactions, or which receives market sensitive information, should adopt and enforce a codes of ethics clearly describing its prohibitions against violative conduct, policies establishing ethical standards, and procedures implementing those policies.

Law firms, in their representation of clients, receive nonpublic, confidential information and should adopt strict procedures which address employee trading and confidentiality.152/ While law firms generally agree that implementing strong policies regarding trading and confidentiality discourages misuse of inside information, firms have adopted varying procedures.

152/ The Commission has warned that the federal securities laws preventing trading based upon nonpublic information extend "not only to partners in the law firm but also to associated lawyers and service personnel employed by the firm." Insider Trading By Law Firm Employees, Exchange Act Release No. 13,437 [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶81,116 at 87,854 (Apr. 8, 1977).

For example, some law firms keep track of employee trading through a computer system available to a few designated partners.153/ Other firms maintain "restricted lists" of securities in which employees may not trade.154/ At my law firm, we require employees to clear all potential securities transactions in writing, in a system monitored by six designated partners, and to refrain from trading until their trades are approved. Generally, law firm employees should be reminded of the procedures through written memoranda and regular briefings, and should be notified that their failure to comply with the procedures could result in dismissal.

In addition to trading restrictions, law firms should develop strong policies regarding confidentiality, and procedures to implement those policies.155/ First, employees should be informed of client transactions solely on a "need-to-know" basis, and only information relevant to the employee's particular responsibilities should be disclosed. Furthermore, the sensitive information should be adequately protected so that only the employees with a "need-to-know" have access to it. For example, code names should be assigned to clients and potentially significant transactions. Locked file

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153/ See, e.g., Security More Crucial Than Ever, Nat'l L.J., June 30, 1986, at 1. See generally T. Levine, Insider Trading: Laws to Prohibit and Procedures to Prevent, 9th Annual Securities Regulation Institute (Jan. 20, 1982); H. Wander, Insider Trading Counseling: Advice to the Law Firm, 14th Annual Securities Regulation Institute (Jan. 23, 1987).

154/ It should be noted, however, that restricted lists may alert employees to potential extraordinary client transactions.

155/ Lawyers are bound by the Model Code of Professional Responsibility, DR 4-101(B)(1) (1987) (as adopted by state legislative action) not to "knowingly reveal" the confidences and secrets of their clients. Lawyers also may not profit or personally benefit by using client confidences. Model Code of Professional Responsibility, DR 4-101(B)(3)(1987).

cabinets should hold stored confidential information. Special safeguards should be employed for word processing and accounting departments, with access lists and tracers to ensure not only that few people are able to retrieve the sensitive information but also that a record of their access is maintained. Confidential drafts which are no longer required should be shredded where practical. These administrative procedures should greatly restrict access to confidential information among the general workforce of the firm.

In my opinion, multi-service brokerage firms should adopt trading and confidentiality procedures for their employees similar to those I have recommended for law firms. Brokerage firms have additional needs, however, because unlike law firms, in which employee trading activity is outside the scope of legal employment, brokerage firm employees may trade on behalf of firm clients and for the firm's own account, as well as for their own accounts.156/

For law firms, multi-service brokerage firms and public companies alike, I suggest that the firm or company policies should be implemented in the following manner. The firm or company should:

1. Adopt formal written policies.

2. Circulate those policies to all new employees immediately on their arrival at the firm.

3. Periodically (usually annually) review and, if necessary, update firm policies to take into

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156/ The Investment banking firms of Goldman Sachs & Co. and Salomon Brothers Inc. tightened their already existing policies regarding employee personal trading in stocks and options. Stewart, Goldman Sachs, Salomon Brothers Curb Staff's Personal Stock, Options Trading, Wall St. J., Apr. 27, 1987, at 2, col. 3. See Pitt on Insider Trading, a book to be published by Prentice-Hall Law and Business (Spring, 1987) (discussion of suggested procedures specific to brokerage firms).

account new developments in the law and lore of insider trading.

4. Recirculate policies periodically (usually annually) to all employees.

5. Hold periodic sessions for administrative and professional employees to sensitize them to the requirements of insider-trading proscriptions.

6. Require all employees who wish to purchase securities to file a written request for authorization before trading is permitted.

7. In the case of brokerage firms, in particular, vigorously enforce a requirement that all securities trades must be conducted through an account or accounts maintained at the same firm that employs the person seeking to trade.

8. Require all employees to certify, periodically, that they have read, understood and complied with each and every requirement of the firm's polices regarding insider trading.

In my practice, I have found it useful for public corporations to develop a formal, written policy for dealing with material nonpublic information within the company and when interacting with the media or others outside the company. This policy should evidence company practices of refraining from responding to rumors for which the company is not responsible, declining to enmesh the company in press or analyst speculation (and particularly non-company projections, not engendered by a company press release), restricting all communications with persons outside the company to one or two knowledgeable corporate officers, and requiring a debriefing with the company's counsel after any communications with the press, analysts or self-regulators.

By adopting such a policy, a company can respond to inquiries by noting that it has adopted, and has consistently adhered to, a formal policy pursuant to which it never comments on press rumors, analysts' speculations, or the like. Of

course, such an approach cannot be breached even slightly, or the company may find itself in an irretrievable position.157/

There is unfortunately, no panacea to guard against the venal employee. The SEC has attracted understandable attention on Wall Street regarding the scope, and the next victims, of its insider trading investigation. Nevertheless, this is an appropriate time for corporations and market professionals alike to review their current policies and procedures to assure themselves that they are doing their utmost to protect against those employees who are well-intentioned but who might miss the mark without sufficient guidance. It takes a considerably long time to create a reputation for integrity, competence and loyalty; it may only take one insider-trading incident to tarnish that reputation.

Q. 5A. In his testimony, Milton Cohen states that self-regulation, in essence, begins with the individual firms. Have the firms failed to adequately self-regulate their trading activities as Mr. Cohen has suggested? What steps have your firms taken to avoid the particular abuses regarding proprietary trading that Mr. Cohen refers to on page 23 of his statement?

Our law firm does not engage in proprietary trading. Please see my response to Question 5 for my detailed comments on the question of the adequacy of self-regulation.

157/ H. Pitt and E. Prater, Guidelines for Dealing with Insider-Trading Cases, Nat'l L.J., June 30, 1986, at 21. The same policies a company adopts for the press and analysts can also be used effectively to respond to self-regulatory inquiries.

Q. 6. Since it appears that self-regulation with regard to insider trading has become somewhat lackadaisical, shouldn't a civil sanction be imposed upon a firm if one of its employees has been found guilty of insider trading and the firm knew or should have known of these illegal activities?

If self-regulation within firms has become lax, in my view the current legal framework for firm liability will operate to bring such firms to task.

Firms have established elaborate procedures for curtailing insider trading opportunities.[158/] Generally, firms require employees to maintain their personal securities accounts at the firm. In those exceptional situations where an employee is permitted to maintain a personal account outside the firm, it is generally required that the firm be able to monitor, and be fully (and promptly) advised of, the activity in those accounts. In their efforts to prevent and/or detect insider trading, whether by an employee or a customer of the firm, firms inquire into questionable trades made for employees' personal accounts, for customer accounts or for the firm's own account in order to determine who initiated the trade (the trader, the broker or the customer) and the basis for the trade, that is, whether the trade might have been based upon a tip. If a "red flag" appears after the initial inquiry, the firm may be obligated to continue the investigation.[159/]

158/ See Pitt Response to D'Amato Question No. 5, supra at 73. See also Stewart, Goldman Sachs, Salomon Brothers Curb Staff's Personal Stock, Options Trading, Wall St. J., Apr. 27, 1987, at 2, col. 3. (the two investment banking firms have tightened their policies restricting employees' personal trading).

159/ See, e.g., In re Prudential-Bache Securities, Inc., Exchange Act Release No. 22,755 [1985-86 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,948, at 87,930 (Jan. 2, 1986).

Difficulty lies, however, in at least two circumstances. First, when trading occurs after market rumors have begun but before a takeover actually is announced, a firm may be hard pressed to determine conclusively whether independent market indicators or an inside tip actually motivated the trade. If the trade appears to have been prompted by legitimate research, and there is no evidence of, or reason to believe that there has been, any improper use of material, nonpublic information, a firm is not, and should not be, required to trace the origin of each of the thousands of transactions it executes each day. Second, certain types of misconduct may not trigger any red flags, and therefore may reasonably go unnoticed by the firm. For example, a customer and broker may act in concert, structuring the transaction in a manner that is unlikely to attract the attention of the firm's compliance personnel. Additionally, if the firm should inquire into such a transaction, it will receive plausible, consistent explanations from the broker and customer. In my view, this kind of deliberate fraud, in which the employee seeks to circumvent and thwart firm procedures, should not prompt firm liability. Indeed, the firm is as much (or perhaps even more of) a victim of such conduct as any other market participant.

Additional considerations are implicated when a firm engages in trading for its proprietary account, because the firm is then in a position to profit from the trading activities of its employees and agents. Multi-service brokerage firms must, and do, carefully monitor proprietary trading to ensure that so-called Chinese Wall procedures are respected, and the requirements of Rule 14e-3 are satisfied. Failure to conduct or adequately pursue investigations of unusual trading, or failure to follow up on patent "red flags" that emerge during such an inquiry, all may lead to firm liability for insider trading carried out in a firm proprietary account, depending on the particular facts and circumstances. These, however, are the easy cases -- they involve a firm that has recklessly failed to exercise its supervisory responsibilities.

The hard cases emerge when a firm detects a suspicious trade, undertakes an appropriate inquiry, uncovers a "red flag" and, following further investigation, is unable to conclude that, in its judgment, any illegal activity occurred. Unless that judgment lacks any reasonable basis, courts should not second-guess these determinations. The securities industry is

subject to the same business pressures as any other industry. Firms should not be compelled, for fear of civil or criminal liability at a later date, to reverse every transaction that is picked up by the firm's exception reporting process. Indeed, the threat of absolute liability for all trades that may later be the subject of an insider trading allegation could drive many financial services institutions out of the brokerage business.

At the same time, firms should not turn a blind eye to obviously improper trading that is being carried out by means of its facilities. Somewhere between the two extremes lies an appropriate standard of supervision to which these firms are held. I believe that the courts and the SEC have adequately defined the parameters of proper supervision by these firms.

Q. 7. Dennis Block, a prominent member of the securities bar, has suggested that insider trading would be less prevalent if a securities firm be prevented from engaging in arbitrage activity where it is also acting as an investment banker to a company involving in a takeover. What do you think about such a prohibition?

In my view, such an absolute prohibition is simply not necessary. As a practical matter, most firms currently maintain procedures which are reasonably effective in preventing a firm from trading for its proprietary account in securities regarding which other members of the firm are privy to material, inside information.160/ It is the rule, rather than the exception, that firms adhere to their strict procedures in order to avoid even the appearance of a conflict, whether or not they are legally required to do so. As a result, I believe that there simply is not a sufficient factual basis to support the proposed absolute prohibition.

The Commission adopted its Rule 14e-3 in order to prevent information abuses and fraudulent practices in the context of tender offers.161/ The rule suggests two types of procedures

160/ See Pitt Response to D'Amato Question No. 5, supra at 73 (a detailed discussion of recommended policies and procedures to deter and prevent trading on insider information).

161/ Securities Act Release No. 6239 [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,646, at 83,459 (Sept. 4, 1980). It also established exceptions to liability for brokerage transactions and multi-service financial institutions. Rule 14e-3(b) provides that an institution is exempt from the "disclose or abstain from trading" proscription of Rule 14e-3(a) if the institution can establish both that individuals making the investment decisions did not know the material nonpublic information and that the institution had implemented one or a combination

Footnote Continued

-- restricted lists, which limit trading in certain securities and "Chinese Walls," which insulate the decision maker from the inside information[162/] -- as possible alternatives for firms to consider in tailoring their policies and procedures to fit their own situation.[163/] Firms are free to establish procedures more rigorous than those enumerated in the Rule, a choice which perhaps would result from the business judgment that stronger procedures are necessary to maintain a high level of customer confidence.[164/] Moreover, when a firm is in possession of material nonpublic information concerning a tender offer, the Commission has suggested that it expects the broker-dealer not to trade for its own account through arbitrage or other proprietary activities because "the burden of proof with respect to knowledge and the effectiveness of the policies and procedures would be more difficult to sustain if the purchases at issue involve such activities."[165/] In my view, this Commission expectation provides adequate disincentives to any firm that might otherwise be tempted to tread close to the line.[166/]

161/ Footnote Continued From Previous Page

of policies and procedures, reasonable under the particular circumstances of the firm and the firm's business, to ensure that the individuals would not violate Rule 14e-3(a) proscriptions. Id. See also 17 C.F.R. § 240.14e-3 (1984) ("Rule 14e-3).

162/ Rule 14e-3(b)(2)(i), (ii).

163/ Securities Act Release No. 6239, supra note 161, at 83,459-462.

164/ Id.

165/ Id. at 83,462 n.46.

166/ I do, however, recommend that legislation should be enacted to require firms which have occasion to receive material nonpublic information to adopt meaningful guidelines which address employee trading and confidentiality. See Pitt Responses to Riegle Issue No. 8, supra at 17; Pitt Response to D'Amato Question No. 5, supra at 73.

Rather than imposing a rigid legislative or regulatory mandate, which could create more problems rather than less, perhaps the current focus should instead be on strengthening and insuring compliance with Commission guidelines and recommended policies and procedures. The New York Stock Exchange's recent distribution of its Special Bulletin is an encouraging example of an approach to meet this goal.167/

167/ See Pitt Response to D'Amato Question No. 13, infra at 98.

Q. 8. The Williams Act, enacted in 1968, was designed to protect investors by ensuring that both bidders and targets play by a federally mandated set of rules during contests for corporate control. In light of some of the perceived "deficiencies" in the Williams Act, do you think that the Act needs a complete overhaul or more of a fine tuning? What specific modifications would you suggest we make without tipping the balance in favor of bidders or targets -- a balance that the authors of the Williams Act sought to create and preserve?

In my view, the Commission has been ill-equipped, in the best of circumstances, to keep pace with rapid private sector innovations in the takeover arena. While I believe that complete Williams Act overhaul may be an appropriate topic for a detailed study, there are areas of fine tuning which I believe are ripe for current Congressional attention.168/

Timeliness and accuracy of tender offer-related disclosure are two key concerns in fine tuning the law. Telecommunications and advanced courier services will assist in the mechanics of allowing reporting times to be drastically reduced,169/ and I believe there is virtually unanimous support for closing the 13D ten-day "window" at least to two days, if not next- or same-day reporting. Similarly, the reporting time frame for Section 16(a) reports of stock transactions by corporate insiders should be reduced from its current period -- ten days after the close of the month -- to two business days after the transaction. These reports provide

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168/ See Pitt Responses to Riegle Issue Nos. 16 and 18, supra at 46 and 51, respectively.

169/ There may, however, need to be adjustments in the current requirements such as the requirement for original signatures on filed documents in order to facilitate the speed of reporting.

essential information to targets and their shareholders, and any advantage gained by the delay of reporting times surely was not intended by the Congress in adopting the Williams Act to tip the balance between bidders and targets during tender offers. Rather, that delicate balance will only be ensured when these cards are placed immediately on the table during play.

Other unfair advantages should be rebalanced as well. In recent times, takeover contests have been characterized by a variety of new techniques, some of which are highly questionable and patently unfair. Unconventional tender offers, creeping acquisitions, open market acquisition programs, poison pills, and the like, when unchecked by appropriate legislation, have in many instances left the securities markets volatile and inflamed, often to the detriment of the investing public. These issues should be addressed by legislation aimed at maintaining the balance you have identified.

The fever pitch with which our markets put company after company "in play" -- Wall Street's terminology for the inevitable demise of a company's independence, in many cases without apparent rationale -- has distracted corporate managements and caused an undue focus on short-term profitability. While tender offers play an important role in providing a check on corporate management, the legislative arena in which tender offers are conducted should be revised to correct its current shortcomings.

Q. 9. Much SEC analysis and media coverage has been given to the New York Stock Exchange's (NYSE) application to the SEC which would enable the NYSE to amend its one share/one vote listing standards. Do you think that the NYSE listed stocks should be allowed to issue shares with disparate voting rights? Does a movement away from the one share/one vote standard mark the death knell for the concept of "corporate democracy?" Should the management of a company that issues stock with disparate voting rights be restricted or precluded from owning stock with full voting privileges in order to avoid management's ability to entrench itself? For the purposes of voting on issues related to changes in corporate control, should the one share/one vote principle apply to companies issuing stock that have disparate voting rights?

For sixty years, the New York Stock Exchange maintained a rule against the listing of non-voting common stock.170/ Various other listing requirements worked together effectively to prohibit dual class capitalization;171/ these requirements thereby established what your question refers to as the NYSE "one share/one vote listing standards." For almost sixty years, the rule apparently served both the Exchange and its issuers well.

170/ New York Stock Exchange Listed Company Manual ¶ 313.00(A) (1983), reprinted in Impact of Corporate Takeovers: Hearings Before the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs, 99th Cong., 1st Sess. 1110, 1140 (1985).

171/ Seligman, Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy, 54 G W. L. Rev. 687, 688-707 (Aug. 1986).

In July of 1986, however, the New York Stock Exchange issued a press release announcing that the directors of the Exchange had approved a dual class capitalization proposal,172/ reversing the rule and opening up to question the issue of whether such a fundamental precept of corporate governance should be left to the exchanges, or even to the Commission as it considers whether to act.173/

I believe that the one-share, one-vote controversy exemplifies the competitive pressures to which our domestic marketplaces may succumb. In facing a call to respond to the exchange actions in eliminating the one-share, one-vote restriction, the Commission has become enmeshed in an issue which, in my view, involves principally a question of corporate governance, traditionally left to the states,174/ rather than to market regulation. I am inclined to believe, in the absence of a compelling argument to the contrary, that the issue of disparate voting rights should be left ultimately to the states, as at present, or be reviewed by the Congress to determine whether there is a federal interest in this subject and, if so, the nature and extent of that interest.

172/ New York Stock Exchange, New York Stock Exchange Directors Approve Amendment to Allow Dual Classes of Common Stock for Listed Companies (Jul. 3, 1986); Sterngold, Big Board Ends Equal Vote Rule, N.Y. Times, Jul. 4, 1986, at D 1, col. 1.

The proposal was prompted by the threats of NYSE-listed companies (some of which have already adopted common stock structures with disparate voting rights) to delist and become traded on the NASD's Automated Quotations System ("NASDAQ") if the NYSE did not adopt such a proposal. NASDAQ does not set standards in this area.

173/ The Commission held a public hearing on March 16, 1987, in conjunction with a conference held on April 7-8, 1987, discussing the uniformity of securities laws. Securities Act Release No. 6690 (Feb. 13, 1987), 52 Fed. Reg. 5367 (Feb. 20, 1987).

174/ See CTS Corp. v. Dynamics Corp. of America, 55 U.S.L.W. 4478 (Apr. 21, 1987) (affirming State interest in creating corporations, prescribing their powers, and defining the rights acquired by purchasing their shares).

Q. 10. Do arbitrageurs play any useful role in corporate takeover contests? Should we consider legislation that essentially eliminates arbitrage activity in battles for corporate control? How could we legislatively limit the arbitrageurs role?

Arbitrageurs play a useful role in corporate takeover contests. Risk arbitrage generally involves investing in the securities of companies which are (or which the arbitrageur believes may become) the subject of publicly-announced acquisition attempts, exchange offers, cash tender offers, corporate reorganizations, liquidations or other similar transactions. As a result, arbitrageurs assume the risk that a proposed transaction will not, in fact, be completed, thereby offering shareholders the option of whether to bear the risk themselves that a proposed transaction will be consummated.175/

Arbitrage techniques are intricate and the decision to invest in certain transactions involves complex analysis. Investing tremendous sums in securities which, based upon in-depth research and experienced projections, the arbitrageur expects may show upward movement, the arbitrageur is able to show gains that individual investors without similar capital and research capabilities are unable to match. Through these purchases, arbitrageurs provide valuable liquidity to the market.176/ Indeed, the Commission has specifically acknowledged that arbitrageurs "are often critical to the

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175/ See generally Johnson, Disclosure In Tender Offer Transactions: The Dice Are Still Loaded, 42 U. Pitt. L. Rev. 1, 10-16 (1980).

176/ See Rule 14e-3, Exchange Act Release No. 17,120 [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,646 (Sept. 4, 1980).

success of tender offers, and can help to promote the liquidity of the capital markets.[177/]

As a result, Congress should not consider legislation that essentially eliminates arbitrage activities in battles for corporate control. To do so would deprive individual investors specifically, and the marketplace in general, of beneficial liquidity. And, such a move would constitute a drastic overreaction to any perceived abuses on the part of arbitrageurs.

If, as a result of recent trading abuses, the Subcommittee is concerned about the proper role of arbitrageurs, I believe it would be prudent to include the subject of arbitrage as a topic to be explored in the Independent Study I previously have recommended.[178/] Once specific abuses have been identified, I have little doubt that appropriate legislation, perhaps including registration and reporting requirements, can be drafted to address those abuses. Legislation requiring registration and enhanced reporting requirements by arbitrageurs may be statutory modifications that would give the Commission increased authority to deal with perceived abuses.

177/ See SEC Amicus Curiae Brief in Connection With Petition for Rehearing, at 6 n.6, Michaels v. Michaels, 767 F.2d 1185 (7th Cir. 1985) (Nos. 84-1631 and 84-1714), cert. denied, 106 S. Ct. 797 (1986), at p. 6 n.6. See also, Exchange Act Rel. No. 15,533 (Jan. 29, 1979), 44 Fed. Reg. 6084, 6089-6090 (Jan. 31, 1979).

178/ Pitt Feb. 24, 1987 Testimony at 8-9, 21-22; Pitt Response to Riegle Issue No. 10, supra at 24.

Q. 11. In his statement, Milton Cohen is critical of the concept of "bridge financing." What useful purposes does bridge financing serve and should there be any regulation of it? What are the abuses that can result from too great a reliance on bridge financing?

Investment banks provide bridge financing, or short-term capital loans, to their clients who are involved in potential or actual takeover transactions, in order to provide interim financing until the client is in a position to negotiate long-term, definitive financing.179/ This practice allows a firm that is already very familiar with the acquiror and the deal to act quickly and quietly in providing certain, short-term financing. Bridge financing has the potential for alleviating much of the uncertainty during a deal -- the focus of the acquiror and of the target can be upon whether the deal makes good business sense rather than whether the acquiror will be able to finance its purchase, or whether preliminary financing discussions outside the investment banking relationship might cause increased opportunity for insider trading.

Various risks have been identified with bridge financing, however. The interim financing may be difficult to refinance after the deal is done. This risk is balanced, on the other hand, by high loan commitment fees, income on the interest spread, and potential underwriting fees for selling the resulting securities after the acquisition is closed, profits over and above the standard advisory fees earned by the investment banker.180/ This additional interest by an

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179/ See, e.g., Campeau Corporation and Campeau Acquisition Corporation acquisition of Allied Stores Corporation stock, during which The First Boston provided the financing necessary to accomplish the acquisition.

180/ Fraidin, Certain Legal Developments for the Offense, Remarks at Law and Business 9th Annual Institute on Acquisitions Conference (Mar. 30, 1987).

investment banker in the success of the deal is troublesome to some, who suggest that when an investment banker adopts the dual role of advisor and investor, an unfortunate compromise can occur. Potential conflicts of interest may arise where the investment banking firm provides both the bridge financing and the underwriting services for a subsequent public offering to refinance the debt.181/ Questions arise as to whether accurate disclosure will be ensured if the investment banker, who normally conducts intensive due diligence into the accuracy and completeness of disclosure, comes to that task with a proprietary financial interest in the success of the offering. Additionally, the added costs of establishing the interim financing as well as the necessary long-term financing may adversely affect the price of the deal.

I am not aware of any actual problems arising from bridge financing. And, regulation of bridge financing already exists, for example, within the Federal Reserve Board's margin rules.182/ It may be prudent to develop more experience with bridge financing before considering it as a subject for possible review.

181/ Id.

182/ These rules limit the extension of credit secured by stock to 50% of the market value of the stock. As a practical matter, this means that bridge financing is generally unsecured. See 12 C.F.R. §§ 207 and 220.

Q. 12. The increased internationalization of the securities market has raised concerns about the ability of the U.S. capital market to remain competitive globally. In his statement, Mr. Shoemaker notes that steps must be taken to ensure that the U.S. market not become outmoded due to regulatory impediments. In the face of increasingly internationalized markets, how can we hope to impose the regulatory standards embodied in our federal securities laws on foreign markets? How can foreign markets be expected to adopt our investor protection and disclosure when their recent growth is due largely to the fact that their regulatory standards are lower than ours?

Issuers whose securities are listed on domestic exchanges must provide detailed (and certainly expensive) disclosure to potential investors, the self-regulators and the Commission. In my view, these traditional regulatory restrictions should be evaluated to determine their contributions and hinderances to our domestic markets which are striving to maintain their respected and envied position among the international markets.183/

The Commission has devoted much time and attention to the subject of how to retain investor protection while facilitating successful competition by our domestic markets with foreign markets. For example, the Commission hosted a roundtable discussion on the internationalization of securities markets on February 17, 1987. In addition to several related topics, the discussion explored the impact of domestic securities regulation upon the United States capital markets. These discussions involved whether securities market regulators remain able, in the wake of the recent proliferation of

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183/ See generally Pitt Responses to Riegle Issue Nos. 7 and 11, supra at 14, 26; Pitt Response to D'Amato Question No. 4, supra at 65.

international securities affiliates, to assure the financial responsibility of their markets, whether the Commission and the self-regulatory organizations should adapt any of their rules, such as the Short-Sale Rule,184/ in order to facilitate the increasing internationalization of secondary markets, the extent to which the reach of the 1933 Act registration process should reach off-shore financings and whether the parameters of that reach should be defined along geographic lines (limited to offerings in the United States capital markets), whether, on a reciprocal basis, foreign companies should be able to issue securities on our domestic exchanges so long as they satisfy their home country's registration requirements, and whether an institutional free-trade zone for investment-grade debt by world-class issuers would be feasible or desirable.

These issues are complex, and raise difficult questions of how adequately to protect investors. The appropriate legislative and regulatory responses to the internationalization of our securities markets should, in my view, be one of the subjects explored in an Independent Study which I have suggested that Congress should commission.185/

184/ See Pitt Response to Riegle Issue No. 13, supra at 38.

185/ See Pitt Feb. 24, 1987 Testimony; Pitt Response to Riegle Issue No. 10, supra at 24.

Q. 13. On February 18, 1987, the NYSE issued a Special Membership Bulletin in which the Exchange "determined that additional resources must be dedicated to meeting our regulatory responsibilities." I am including a copy of this Bulletin for your convenience. Do you feel that the NYSE recommendations are adequate or must Self-Regulatory Organizations take on even more responsibilities than those described in the Bulletin?

In its Special Membership Bulletin, the New York Stock Exchange notified its members of four new requirements designed to encourage its members to "strengthen their legal and compliance functions and demonstrate to the Exchange that they are meeting their supervisory and compliance responsibilities."186/ The Exchange, in return, committed itself to intensifying its own investigative efforts, upgrading its internal standards for particular systems and personnel essential to the investigatory process, and "establishing better liaison" with the Commission in joint efforts to detect market irregularities and prosecute for violations.187/

I believe the Exchange is to be commended for its efforts, and for encouraging its members and the other exchanges to take more seriously their responsibilities to the marketplace. These efforts are an important foundation on which a comprehensive program can be built.

186/ New York Stock Exchange Special Membership Bulletin (Feb. 18, 1987). The exchange now requires members to review and enhance their internal supervisory and compliance efforts, to certify to the exchange, on a quarterly basis, that proprietary and employee trading activity was reviewed to ensure compliance, to report customer complaint letters to the exchange, and to prepare an internal annual report detailing the year's compliance problems, their resolution, and the company's supervisory and compliance initiatives. Id.

187/ Id.

The exchanges are in a unique position, as recognized by proponents of the 1934 Act, to take "nonlegal, quick-acting, nonreviewable disciplinary measures [which can] never be adequately replaced by the slower moving processes of an administrative agency or the courts."188/

The notion underlying self-regulation throughout the history of securities regulation under the 1934 Act has been that the industry can do a better job of articulating ethical standards for its various individual and institutional components than can the government.189/ When market participants are able to regulate themselves, their expertise in the detailed workings of the marketplace enhances the prospect of developing ethical guidelines that will work. The honest evaluation of market problems, by market participants working together with their self-regulators, provides the best basis for creating guidelines effectively addressing those problems.

Even today, with the media questioning the ethical precepts by which the various constituents of the securities industry function, entrusting the development of ethical standards to industry self-regulators makes a great deal of sense, provided, of course, that the industry's self-regulators dedicate themselves to the important tasks at hand, and satisfy the public that they are capable of performing this undertaking effectively and on a timely basis, as I believe they are. The New York Stock Exchange's February 18 Special Bulletin is an example of this type of self-regulatory action; it should not,

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188/ Report to the Secretary of Commerce of the Comm. on Stock Exchange Regulation, 73d Cong., 2d Sess. 12 (1934).

189/ See Stock Exchange Regulation: Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 544 (1934); Act of June 25, 1938, ch. 677, 52 Stat. 1070 (the adoption of the Maloney Act); Securities Act Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565; Pub. L. No. 94-29, 89 Stat. 97 (Jan. 4, 1975)(the Securities Act Amendments of 1975).

however, be the end of the effort. Standard setting is the strong suit of the various self-regulatory organizations, and the Bulletin is but a beginning.

Among other things, I believe that the other self-regulatory organizations need to take action comparable to those of the NYSE. In addition, the various self-regulatory organizations should become more involved in assessing brokerage firm procedures and policies, and assisting firms by developing model programs. Increased surveillance by the self-regulatory organizations will also serve to discourage or uncover violative conduct. Indeed, I believe that the formation of an inter-SRO task force, combined with the active participation of brokerage firm compliance officials, would be useful in contributing to the elimination of insider trading abuses.

Q. 14. In the testimony of Robert Rittereiser (see p. 7) he states that the development of derivative products such as options and futures when combined with program trading creates a problem of extraordinary market volatility during those 4 Fridays of the year with "triple witching hours."

(a) Is this volatility only limited to 4 triple witching hours each year? (The 114 point swing in the market on January 23, 1987 was not on a triple witching hour Friday; the 120 point drop on September 11 and 12 was not on a triple witching hour Friday.)

(b) NYSE Chairman John Phelan recently expressed his concern that a failure to curtail the volatility of a program trade driven stock market could lead to a 1929-style market crash. Do you agree with Phelan's assessment and how could such a crash be triggered by program trading? How likely is the occurrence of such a market calamity?

(c) What specific regulation of program trading activity is required?

As your question points out, volatility within both domestic and foreign markets is not limited to the "triple witching hours" on four Fridays each year. The Division of Market Regulation of the SEC recently issued its analysis of the market decline which occurred on September 11 and 12 of 1986. In that report, the Division indicated that close monitoring of index-related trading should be maintained, perhaps through enhanced reporting and recordkeeping procedures, and that "continued careful analysis of the potential for disruption of the stock market as well as manipulative or other inappropriate trading in the index products and their component stocks" is required. 190/

190/ The Role of Index-Related Trading in the Market Decline on September 11 and 12, 1986, at Executive Summary (Mar. 1987) (the "Index Trading Study").

The Division's review of market volatility occurring on those two days suggested that the large decline in the market was "triggered by changes in the perception of investors regarding investment fundamentals," rather than by "technical factors unrelated to market fundamentals."191/ Had index-related trading alone been the cause of the 120 point decline, the Division reasoned, the market should rapidly have reversed a significant portion of its decline, a phenomenon which does accompany "triple witching hour" trading volatility.192/ Thus, the tremendous drop in the market which occurred on September 11 and 12, 1986, was not, according to the Division, attributable to index trading. The Division acknowledged, however, that the futures market might have impacted upon the trading decline by "condensing into a shorter time period a price change that would have occurred in any event."193/

It is inevitable that new market innovations, such as program trading, will impact upon the stability of our market. The market will stretch to interpret the impact of each new phenomenon, an impact that often loses impetus as the market grows accustomed to the innovation.

I do not believe there is any empirical basis to conclude that program trading will cause the market to crash. I do believe, nevertheless, that serious study should be directed at what effects program trading might have upon the market and what regulation of program trading might combine the respect for innovation and research due to those who engage in such trading with safeguards which might be beneficial to the marketplace.

In this respect, program trading is not a unique phenomenon. In the late 1960's, when our securities markets evolved into markets that were overwhelmingly institutional in composition, analysts and Congress grew concerned about a

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191/ Id. at 2.

192/ Id.

193/ Id.

phenomenon often referred to as "parallel trading" -- the notion that large institutions, with their access to expert analysis, tended to trade the same way, in the same stocks, at the same point in time.[194/] Rather than respond to these concerns with legislative initiatives, Congress authorized the Commission to perform a study of the implications on our markets of institutional investors[195/], in general, and of so-called parallel trading, in particular.[196/] Ultimately, it was concluded that no regulatory response was appropriate, although Section 13(f) of the 1934 Act was adopted to provide a data base for evaluating the impact of institutional investors on the market.[197/]

As I mentioned in my testimony and in responses to other issues posed by the subcommittee staff[198/], I believe the time is ripe for Congress to commission a full scale study of the efficacy and shortcomings of our securities laws and regulations, with a view toward possible revisions which would provide our marketplace with the appropriate regulatory framework to manage these new phenomenon. I believe that the Independent Study should include program trading, and the issues raised by the SEC's Division of Market Regulation, in the Index Trading Study.

194/ See, e.g., SEC, Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. (1966), pp. 289-290, 302; 2 SEC, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88 Cong., 1st Sess. (1963), p. 839; Staff of the Senate Comm. on Banking and Currency, Institutional Investors and the Stock Markets, 1953-55 (1956), p. 46.

195/ See Pub. L. No. 90-438, 82 Stat. 453 (1968).

196/ 4 SEC, Institutional Investor Study Report, H.R. Doc. No. 92-64, 92nd Cong. 1st Sess. (1971), pp. 1397-1536.

197/ Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 119.

198/ See Pitt Feb. 24, 1987 Testimony at 8-9, 22-23; Pitt Response to Riegle Issue No. 10, supra at 24.

Q. 15. Some critics of program trading suggest that it is nothing more than a sophisticated form of market manipulation. How do you respond to such criticisms when it appears that a firm such as Salomon Brothers could turn the market around in a short time based on its own buy orders? (On December 19, 1986, the market was down between 5-10 points during the last half hour of trading. Salomon initiated a buy program and turned the market around by ordering the purchase of $2 billion worth of equities at the close. The market finished up 16.03 points with trading of 118.5 million shares in the final hour.)

Program trading may have had significant effects upon our marketplace, but does not fall,[199/] per se, within classical concepts of market manipulation.[200/]

Q. 16. It appears that the investor who has the potential for downsider risk in a market dominated by program trading is the small investor. Does program trading have the effect of locking the small investor out of the market? Should small investors avoid trading on those triple witching hour Fridays?

As I have noted previously,[201/] the issues raised by program trading are significant and deserving of careful study, and thoughtful recommendations. I am reluctant to reach conclusions, or make recommendations vis-a-vis small investors, in the absence of a meaningful study of the issue.

199/ See Pitt Feb. 24, 1987 Testimony at 8-9, 22-23; Pitt Response to Riegle Issue No. 10, supra at 24.

200/ "Manipulation is 'virtually a term of art when used in connection with securities markets' . . . [and] refers generally to practices, such as wash sales, matched orders or rigged prices, that are intended to mislead investors by artificially affecting market activity." Santa Fe Industries v. Green, 430 U.S. 462, 476 (1977), citing Ernst & Ernst v. Hochfelder, 425 U.S. 1375, 1384 (1976). See 1934 Act Section 9(a), 15 U.S.C. § 78i (1982).

201/ See Pitt Responses to D'Amato Question Nos. 14, 15, 17, 18 and 19, infra at 99, 102, 104, 105 and 106, respectively.

Q. 17. It appears that program trading is triggered by trends in the options and futures index rather than by more traditional methods of analysis regarding a buy or sell recommendation. What do you perceive as the effects of this major shift from trading stocks, not on fundamentals such as a company's earnings and dividends, but on technical computer strategies that can drastically swing the market in minutes?

As I have noted in response to earlier questions,202/ it is difficult -- in the absence of a comprehensive study of the subject -- to assess the effects of program trading. The question, as posed, presupposes a bias in favor of securities trading "on fundamentals," rather than on computer strategies.

In the absence of empirical data, evidencing untoward damage (or potential damage) to our capital markets, investors should be free to rely on any analytic model they choose (so long as the model does not involve wrongfully obtained or utilized information). As a conceptual matter, I would be reluctant to see the enactment of legislation mandating that investments be predicated solely "on fundamentals." Market liquidity is a direct function of diverse analytical methodologies, and Congress shcould refrain from legislating in this area without compelling evidence that (i) a real problem exists, and (ii) a viable solution is available.

202/ See Pitt Responses to D'Amato Question Nos. 14, 15, 18 and 19, infra at 99, 102, 105, and 106, respectively.

Q. 18. How much of your firm's capital is committed to program trading? Are borrowed funds used to engage in program trading?

Our law firm engages in no proprietary trading, and therefore commits no capital to program trading.

Q. 19. If substantial arbitrage programs are unwound in the same direction late on an expiration day, an extreme imbalance of orders may result that sends the market plummeting. How can exchange specialists attempt to make an orderly market when faced with such imbalances. What's being done to handle a large unwinding of exchange positions in the market? How successful was the plan agreed on by the NYSE and the SEC where so-called market on close orders in certain stocks were required to be submitted at 3:30 p.m. rather than 4:00 p.m. when the market actually closed?

Exchange specialists and the SEC have, in my view, worked effectively to balance the effect of major market unwinding on those four times each year known as "triple witching hour" days. As your question indicates, the NYSE and the Commission have worked together to guide voluntary trade reporting prior to closing in order to provide information regarding order imbalances early enough to allow the market to react. Although in some cases the offsetting maneuvers have been questioned,[203/] reports following the most recent "triple witching hour" day indicated that both the SEC and the market traders were pleased at the way trading was handled.[204/]

As I have indicated elsewhere in this testimony,[205/] I

203/ See Pitt Response to D'Amato Question No. 15, supra at 102.

204/ Garcia, Abreast of the Market: Tamer Triple Witching Hour Takes Stocks, Futures Prices to Record Highs, Wall St. J., Mar. 23, 1987. (one source, Mr. Joseph Schmuckler, Vice President in the Financial Futures Department of Kidder, Peabody, noted that "the market is maturing and it was business as usual").

205/ See Pitt Responses to D'Amato Questions Nos. 14, 15, 16, and 17, supra at 99, 102, 103 and 104, respectively.

believe that the progress of the Commission and the exchanges as they strategize to offset the tremendous capacity for market volatility on those four days each year, as well as the overall impact of program trading on our securities markets, are appropriate topics for the Independent Study I have proposed. These issues have not been examined by the major market studies conducted in years past;[206/] I believe it is essential that Congress take the lead in examining the impact of recent market innovations and the counterbalancing regulatory responses in order to determine whether additional legislative initiatives should be pursued.

206/ See Pitt Response to Reigle Issue No. 10, infra at 24.

Q. 20. Do you believe that the Delaware court's decision in Unocal Corp. v. Mesa Petroleum[207/] was correct? Do you think that the Commission was acting correctly when it adopted the so-called "all holders" rule.

It is not clear that the question posed -- whether the Unocal decision was correct -- should properly be the focus of inquiry. Unocal is, and was, a Delaware corporation, governed by Delaware corporate law. These are facts of which Mesa Petroleum was well aware before it ever purchased a single share of Unocal stock. As a result, the fact that the Unocal decision was rendered by a Delaware court, applying Delaware law, makes it difficult to challenge the "correct[ness]" of the decision.

There are, however, two fundamental questions posed by the decision, one of which is raised by the Subcommittee. The first question is what role, if any, state law should play in the governance of contests for corporate control. The second question is the second one posed above -- whether the SEC "was acting correctly when it adopted the so-called 'all holders' rule."[208/]

207/ Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

208/ SEC Exchange Act Rule 13e-4(f)(8), to be codified at 17 C.F.R. § 240.13e-4(f)(8) (1986). The SEC stated that "[t]he objective of the all-holders requirement * * * is to make explicit the requirement that issuers and bidders alike must extend their tender offers to all holders of the class of securities being sought in the tender offer and must pay every tendering security holder the highest consideration paid to any other security holder." Exchange Act Release No. 23,421 and Investment Company Act Release No. 15,199 (July 11, 1986).

Since the second question is somewhat easier to address, it seems the appropriate place to start. The SEC's apparent purpose in adopting the so-called "all holders" rule was, at least in part, to effect a reversal of the Unocal decision.209/ This was not the first time the Commission has addressed a rule for the specific purpose of overruling state law.210/ Whatever the subject, I do not believe it is appropriate for the Commission to exercise its rulemaking power in such a way as to reverse state law except in cases where the need for such a rule is great and the Commission can point to a clearly-articulated Congressional policy which the rule is implementing. I do not believe either predicate was met here.

The Unocal decision represented a unique factual situation. Whatever the merits of the Delaware Supreme Court's holding, the decision reflected the application of Delaware law by the highest court of that state. The agency's decision to preempt Delaware law raises significant concerns about the propriety of the agency's use of its rulemaking power.

Even apart from the question of the propriety of the SEC's reversal of the Delaware Supreme Court, the SEC's exercise of its rulemaking power in adopting the so-called "all holders" rule is troublesome. Nothing in the Williams Act suggests that Congress would have resolved such a major policy question the

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209/ Only one month after the written decision was released in Unocal, the Commission proposed a new rule (which, with few revisions, was adopted in July, 1986) affecting bidders making a tender offer under Section 14(d) of the 1934 Act. Exchange Act Release No. 33-6595 (Jul. 1, 1985) 50 Fed. Reg. 27976.

210/ See, e.g., Canadian Pacific Enterprises, Inc. v. Krouse, 506 F. Supp. 1192 (S.D. Ohio 1981) (the court ruled that the Commission's Rule 14d-2, 17 C.F.R. § 240d-2 (1986), which forbids the public announcement of a tender offer more than five days before it is made, was valid and pre-empted an Ohio takeover statute which required a public announcement of the takeover bid at least 20 days before it was made).

way that the Commission in fact did. Whether or not the SEC's rule is within its rather broad rulemaking authority,211/ some rulemaking should be deferred in favor of legislation; in my view, this was such a situation.

As noted above, the more difficult question is whether state law should influence the rules pursuant to which tender offers are contested. Just this week, the Supreme Court noted that there is a permissible role for states to play in the regulation of some facets of a tender offer:

> [i]t thus is an accepted part of the business landscape in this country for States to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares. A State has an interest in promoting stable relationships among parties involved in the corporations it charters. A change of management may have important effects on the shareholders' interests; it is well within the State's role as overseer of corporate governance [to allow] shareholders collectively to determine whether the takeover is advantageous to their interests.212/

211/ Section 23(a) of the 1934 Act defines the Commission's rulemaking authority as including "the power to make such rules and regulations as may be necessary or appropriate to supplement the provisions" of the 1934 Act, for which the Commission is responsible, or "for the execution of the functions vested in them" by the 1934 Act. 15 U.S.C. § 78w(a)(1) (1982).

212/ CTS Corp. v. Dynamics Corp. of America, 55 U.S.L.W. 4478 (U.S. Apr. 21, 1987) (upholding Indiana state takeover legislation).

Precisely how large the states' role should be was not decided by the Supreme Court, and should not be decided by the SEC. If Congress ultimately decided to legislate, in a comprehensive fashion, the entire range of defensive responses to unsolicited hostile takeover offers, the "all holders" rule, or some variant thereof, might make eminent good sense. But until this question has been studied carefully, and a meaningful legislative record developed, the SEC should not adopt such regulations by administrative fiat.

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